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No. 18198

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

STEPHAN RIESS and THELMA MCKINNEY RIESS,
Appellants and Cross-Appellees,

vs.

C. W. MURCHISON and SIMI VALLEY DEVELOPMENT COMPANY,
Appellees and Cross-Appellants.

APPELLEES' AND CROSS-APPELLANTS' CLOSING BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

PAGE

STATUTES

TEXTBOOKS

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Introductory Statement.

Appellants and Cross-Appellees ("Appellants" herein) begin their Consolidated Reply Brief on Appeal and Brief on Cross-Appeal (the "Reply Brief" herein) with a statement of points which bear brief analysis:

First, in their point "First" (Reply Br. pp. 1-2) Appellants suggest that we have changed our position in transit between the trial and the appeal: that whereas at the trial we advocated our position on factual grounds, we now urge it on legal grounds. The truth is—and this can come as no surprise to Appellants, as hereinafter appears—that we have at all times urged it on *both* bases, *i.e.,* the legal ground that the con-

tract is not susceptible to breach by anticipatory repudiation; the factual ground that even if the doctrine of anticipatory repudiation applied, the admitted and undisputed facts would not justify its invocation.

That the Trial Judge had both bases in mind is manifest from Conclusion of Law II, which reads as follows:

"II.

"The breaches of contract found to have been made by the defendants were not of such kind and character which, under the law and the undisputed facts, constituted breach by anticipatory repudiation so as to require the conversion of an obligation to pay specified amounts of money (or at the option of defendants, specified quantities of water) in futuro measured by the amount of water produced, saved, and sold from the Water Lands, into an immediate obligation for the payment in cash of all possible future obligations." [Clk. Tr. p. 356, lines 12-20.]

There were admitted facts, among them:

"V.

"That between March 20, 1956, and June 12, 1956, defendants C. W. Murchison and Simi Valley Development Company paid, or caused to be paid to plaintiffs, the sum of $50,000 of the purchase price for said properties, as set forth in paragraph 2(b) of the First Agreement (Plaintiffs' Exhibit 'A'). That in addition, during the period from May, 1955 through September, 1957, the further sum of $58,000 was paid, or caused

to be paid to plaintiffs, by defendants C. W. Murchison and Simi Valley Development Company, in 29 equal installments of $2,000 each; $28,000 of said sum having been paid to plaintiffs during the period from May, 1955 through June 12, 1956; and the remaining $30,000 of said sum having been paid to plaintiffs during the period from June 12, 1956 through September, 1957; and no other sums have been paid." [Clk. Tr. p. 165, lines 8-20.]

There were undisputed facts. Of particular moment was Mr. Riess' testimony that he and Mrs. Riess received the one-sixth stock interest in Simi Valley Development Company [Rep. Tr. p. 83, line 23], and that there had been no repudiation of the contract. [Rep. Tr. p. 222, lines 6-10; p. 223, lines 8-11; p. 228, lines 4-20; p. 229, lines 9-14; p. 293, lines 2-8; p. 349, lines 2-7.] (All quoted, Appellees' Br. pp. 24-26.)

The suggestion of Appellants that the legal ground for sustaining the judgment is advocated for the first time on appeal would be specious if correct, the particular and specific *ratio decidendi* being immaterial to the appeal. What matters is whether the judgment can be sustained on any basis. But it is doubly specious in that it is belied by the Findings of Fact and Conclusions of Law *proposed by Appellants themselves* for the signature of the learned Trial Judge. [Clk. Tr. pp. 320-328.] The attention of the Court is particularly invited to Conclusion of Law II, from which it is apparent that Mr. and Mrs. Riess were aware that the judgment was based, at least in part, on legal grounds, and judging by the Conclusions of Law proposed by them, in whole on such grounds:

"II.

"The contract between plaintiffs and Murchison, which is the subject matter of the within action, is of such kind and character that any breach of any of the terms thereof by Murchison or his assigns could not and did not constitute an anticipatory breach." [Clk. Tr. p. 325, lines 23-26.]

Second, and with reference to the argument at page 2 of the Reply Brief, the condition to Appellees' obligations was a condition precedent, with the burden of proof upon the Appellants (Appellees' Br., Point II A, B; Point II, *infra*).

Third, Appellants suggest (Reply Br. pp. 2-3) that Appellees view the contract as "in the nature of a lease calling for royalty payments, with payments dependent solely upon production," and point out that the leasehold analogy breaks down because of the absence of a remainder or reversionary interest. In so doing, Appellants have injected a false issue into the case, and then proceeded to demonstrate wherein it is fallacious. Strawmen aside, at no point is such an analogy drawn in our brief, nor have we at any time suggested that the contract is anything but what its unambiguous and unequivocal content makes it out to be. In the context of the clear language used by the parties, analogies have seemed to us unnecessary.

As we have heretofore pointed out (Appellees' Br. pp. 4-5), the contract called for the issuance to Appellants of one-sixth of the capital stock of Simi, and for the payment to Appellants of $98,000 as a fixed and absolute obligation. Payment of more than that sum in cash was made contingent upon water produc-

tion at 10¢ per 1,000 gallons produced, saved and sold. If production failed to generate a minimum of $24,000 a year at the specified rate, Appellants had the right, but not the obligation, to take water at the well-head in lieu of the cash they would have received had there been sufficient production. Under no circumstances were payments to Appellants to exceed $1,000,000. [Ex. 1 in evid., sec. 2(b).] Thus, the assertion that the "purchase price . . . under the agreement is One Million Dollars" (Reply Br. pp. 2-3) is the child of a misconception of the agreement. The $1,000,000 represents the ceiling, not the floor; by their contract, the parties agreed that the purchase price could never under any circumstances exceed $1,000,000, but there is nothing in the contract to justify the conclusion that willy-nilly, and without reference to production, it was to be $1,000,000, not a penny more, not a penny less.

Fourth, if we correctly understand Appellants' position as stated in their Point Fourth with respect to the dismissal of the jury, it is not that they claim to have been prejudiced by the fact that their case was not passed upon by the jury, but rather by the "reversal of position" on the part of the Trial Court which "resulted in the entry of a judgment expressly based upon Findings of Fact which invade the province of the jury." (Reply Br. pp. 3-4.) Any reversal of position here is that of Appellants, not the Trial Court. At the close of proceedings Appellants were asked by the Trial Judge to propose and prepare Findings of Fact, Conclusions of Law, and Judgment. [Rep. Tr. p. 508, lines 16-23.] They did so. [Clk. Tr. pp. 320-328.] Among the conclusions proposed by them were conclusions without either record support, or, indeed,

support in the proposed findings. For example, they proposed that the Court decree an estoppel, the effect of which would have been to excuse them from showing the happening of the condition precedent to liability and to preclude Appellees from asserting the insufficiency of the water [Clk. Tr. p. 326, lines 26-27]; they proposed that the Court decree a waiver of any claim that the Water Lands were incapable of producing sufficient quantities of water. [Clk. Tr. p. 326, line 29, to p. 327, line 1.]

The Court conducted a hearing to settle Findings and Conclusions. Those ultimately adopted by the Court ensued. Appellants who, with no record support whatever, proposed conclusions invoking the doctrines of waiver and estoppel, should not be heard to object to the making of a finding that there was no repudiation, when the record is replete with Appellants' own testimony to that effect. (Appellants' Br. pp. 24-27.)

I.

THE CONTRACT COULD NOT HAVE BEEN TOTALLY BREACHED OR ANTICIPATORILY REPUDIATED.

A. Appellants Seek Unduly to Restrict the Rule.

Appellants concede that the authorities upon which we rely represent the views of this and the Supreme Court of California. They argue that we are attempting to extend them to a factual pattern to which they do not apply. Secondarily, they suggest that this is the point at which a halt should be called to the application of the rule, thereby granting time for Professor Corbin's observations to creep into the law via the rear entrance, this and the California courts having

barred the front door in a plethora of cases heretofore cited. (Appellees' Br. pp. 11-24.) Most recently and dramatically in *Minor v. Minor,* 184 Cal. App. 2d 118, 126 (1960), the Court made it clear that Professor Corbin's views on the subject do not represent the substantive law of California [which is the law to be applied in this cause under the doctrine of *Erie R. Co. v. Tompkins,* 304 U. S. 64, 78, 82 L. Ed. 1188 (1938)] in the following language:

> "Whatever the theoretical considerations may be . . . California law, however, has marked the stopping place, and we accept it."

Moreover, the rule is neither as precise in terms or application as Appellants urge, nor is it to be limited to as narrow a field of contracts as Appellants would like, *i.e.,* insurance contracts, promissory notes, and leases. *Minor v. Minor, supra,* was a property settlement agreement calling for the payment of money in instalments, yet the doctrine was applied. It was also applied in *Farmer v. Mountain Lake Club,* 94 Cal. App. 663, 664 (1928), a contract for payment for services, and in *Flinn & Treacy v. Mowry,* 131 Cal. 481, 486 (1901), a similar contract.

One must sympathize with Appellants' manifest effort to find precision and certainty in their short and highly selective quotation from the opinion of this Court in *John Hancock Mutual Life Insurance Co. v. Cohen,* 254 F. 2d 417 (9 Cir. 1958). Their quest is as old as the law. The conceptual has charms which will forever be denied the pragmatic, which has only reason to recommend it. They have seized upon the word "unconditional" in Judge Barnes' most thorough opin-

ion in *John Hancock Mutual Life Insurance Co. v. Cohen, supra* (quoted Reply Br. pp. 5-6) as the touchstone to their concept, not recognizing that in the context used "unconditional" can have no meaning other than "*executory on one side only.*" Semantics apart, however, it should be noted that the rule is stated without reference to conditions by Judge Barnes elsewhere in the same case (*supra,* 254 F. 2d at p. 426):

> "We conclude the general rule to be that the doctrine of anticipatory breach has no application to suits to enforce contracts for future payment of money only, in instalments or otherwise. . . ."

This case, we respectfully submit, is a suit to enforce a contract for the future payment of money.

1. The Condition to Liability Bars the Assertion of Any Breach, Anticipatory or Otherwise.

As we understand the argument of Appellants, it would appear that they contend that there can be anticipatory breach of an agreement where the existence of the obligation to perform is subject to a condition precedent, but that there cannot be anticipatory breach of an agreement where the obligation is in being. It is respectfully submitted that their argument defies logic. Yet it must be conceded that the word "unconditional" does appear in the cases. The vice of the argument, therefore, must lie in the meaning ascribed by Appellants to the word "unconditional," and we believe a clue to its proper meaning can be found in comment (a) to section 316 of the *Restatement of Contracts,* wherein it is stated that:

> "Where a unilateral contract or a bilateral contract that has been wholly performed on one side,

> is for the payment of money in instalments, or for the performance of other acts, not connected with one another by a *condition having reference to more than one of them or otherwise,* a breach as to any number less than the whole of such instalments or acts is partial." (Emphasis added.)

It is respectfully submitted that when the Courts speak of the agreement being "unconditional," they mean, in the language of the Restaters, that the instalments or other acts are not connected with one another by a condition having reference to more than one of them or otherwise, not unconditional in the sense of not being subject to a condition precedent, as we view the conditions, or of a condition subsequent, as it is viewed by Appellants.

To make the applicability or non-applicability of the doctrine of breach by anticipatory repudiation turn upon the presence or absence of an unrelated condition, would be a *non sequitur.* One can have nothing to do with the other except in the sense that where an obligation is subject to a condition precedent, not shown to have occurred, then there can be no breach of the obligation, anticipatory or otherwise. It is simply not capable of being breached in any manner. It is respectfully submitted that this is the type of obligation with which the parties are dealing in the present case, and this point has, we believe, been sufficiently developed in Point II of Appellees' Brief.

2. **The Agreement, While Originally Bilateral, Became Unilateral Upon the Delivery of the Deed by Appellants.**

Recognizing that the doctrine of anticipatory breach cannot be applied to a unilateral contract, Appellants have sought to warp certain portions of the agreement into executory contractual obligations on their part. The two found and referred to at pages 26-28 of Appellants' Opening Brief have, we think, been sufficiently met by the discussion at page 12 of Appellees' Brief. They now find a third "executory" obligation on their part to be performed in paragraph (h) of the agreement, which gives to Appellees the right, at their election, to reconvey the wells to Appellants, and requires Appellants to accept them in extinguishment of Appellees' obligations. Both "unperformed" obligations which Appellants seek to impose upon themselves have one common characteristic: absent some act on the part of Appellees, they do not exist. More particularly, unless Appellees request the location of wells, Mr. Riess is under no obligation to locate them. No request has been made. Unless Appellees elect to reconvey the wells, Appellants are under no obligation to accept them. No such election has been made. So far as the arbitration "covenant" is concerned, it has heretofore been pointed out that this is a matter of remedy, not of substantive right. And finally, it should be remembered that paragraph XVII of the first amended complaint contains an allegation to the effect that Plaintiffs (Appellants) have performed all of the covenants and agreements to be performed by them. [Clk. Tr. p. 29, lines 26-30.]

Federal Life Ins. Co. v. Rascoe, 12 F. 2d 693 (C. C. A. 6, 1926) is of interest, not only so far as the dissenting opinion, cited by Appellants, is concerned, but in its entire treatment of the problem. In that case plaintiff sued on a policy of disability insurance, which it was alleged the defendant company had repudiated. Under the terms of the insurance contract plaintiff was required, every thirty days, to submit a report in writing from her attending physician with respect to her disability. This she had done. She sued for anticipatory breach of the insurance contract, and the majority of the Court held that she could do so. Judge Donahue, speaking for the majority, acknowledged that there can be no anticipatory breach of a unilateral contract for the payment of money at some future date (*supra,* 12 F. 2d at p. 695), but then went on to point out that the contract there in question was not a unilateral contract. He noted that every thirty days plaintiff was required to "submit her person to the examination of a physician and pay the physician . . ." (*supra,* 12 F. 2d at 696), pointing out that this was not merely a technical requirement, but a substantial and continuing burden then in being. This, it is respectfully submitted, is quite different from the ephemeral unperformed obligations which Appellants find in the contract, which do not become obligations without some action on the part of Appellees which has never been taken. Judge Denison, dissenting, saw even the covenant to submit herself to the periodic physical

examination as a mere condition, and concluded that the contract was unilateral, so that the doctrine of breach by anticipatory repudiation would not apply. In addition, in a case involving facts much stronger, it is respectfully submitted, than the facts in the instant case, he failed to find repudiation. While he did say, "I do not understand that a contract sued upon is executory, as against a plaintiff, unless it binds him to do something, so that an action may lie against him for specific performance, or for non-performance" (*supra,* 12 F. 2d p. 693), the statement now can be seen in context. In our case, the Appellants are not bound to do anything further than what they have already done.

Appellants suggest that at pages 27-28 of Appellees' Brief we have sought to impose an obligation to demand payment in kind, *i.e.,* water, upon them, another executory and unperformed covenant. Our argument at the portion of our brief cited was that Appellants had an option, not an obligation.

We suggest that Appellants' difficulty in construing the agreements lies in their confusing the concepts of obligations under an agreement and rights under an agreement. Both parties to a unilateral agreement have rights under the agreement; only one of them, however, has obligations.

Winegar v. Gray, 204 A. C. A. 332, 337-338 (1962) does, indeed, state the familiar rule that every contract contains an implied obligation of good faith and fair dealing upon the part of each of the contracting parties. The law of contract knows no more salutary rule, but it has no application to the instant case.

3. The Agreement Is of the Type Which Cannot Be Anticipatorily Breached.

Appellants put forward the proposition that the contract is not one for the payment of money in instalments, from which they conclude that the doctrine of anticipatory breach may apply. It is certainly a contract for the payment of money, and equally certain it is not a contract for the payment of money in a lump sum, but in instalments over a period of time ratably with water produced, saved, and sold. All other covenants in the contract were either in aid of, or unrelated to, the agreement to pay money in instalments. Appellants misconceive our argument as to the obligation to pay in kind: there was never an obligation to pay in kind, but there was a right which Appellants did not exercise [and which therefore never became an obligation of Appellees] to call for payment in kind. Our argument in essence has been, and continues to be, that if water production did not create a cash obligation, then there was a right which Appellants might exercise to call for water. This was the remedy given them in the contract. They did not choose to pursue it, but rather to attempt to rewrite the contract. (Appellees' Br. pp. 27-30.) And finally, if it be assumed that the performance which, at the time of the alleged breach, had not yet become due, called for an exchange of something other than or in addition to, money, it is difficult to see why the rule should be any different. The *Restatement* makes it clear that where a bilateral contract that has been wholly performed on one side is for the payment of money in instalments, *or for the performance of other acts,* a breach as to any number less than the whole of such instalments *or acts* is partial

only (comment (a), sec. 316, *Restatement of Contracts*). In *Minor v. Minor, supra,* the Court does not confine the rule to instalment contracts for the payment of money only, but rather to the breach of unilateral contracts generally, or agreements fully performed by the complaining party which upon such performance become unilateral. There is no reason why the rule should be otherwise.

4. The Rule Applied by the Trial Court Is Neither Restricting nor Inapplicable.

In characterizing the rule applied in the cases relied upon by Appellees as "restricting," Appellants imply the premise that the common law favors the application of the doctrine of anticipatory breach. The doctrine of anticipatory breach is itself a judicial innovation in the pre-existing rules of the common law, and as such, must itself be limited.

> *Minor v. Minor, supra,* 184 Cal. App. 2d at p. 126.

In addition, in advancing the argument made in section I-A-4 (Reply Br. pp. 9-11), once more Appellants have tailored the agreement to fit their argument. There was no absolute obligation to install and construct the water system alluded to: the undertaking to do so was expressly conditioned upon the "physical ability of the well or wells now or hereafter located on the Water Lands to produce sufficient quantities of water. . . ." [Clk. Tr. p. 37.] Appellants had "expressed protection" other than that noted at page 10 of their brief. They had the right, if water production was insufficient, to take water at the well-head. [Clk. Tr. p. 36.] In addition, they had a further protection which they neglect

to mention, but which was implicit in the transaction. Appellees' stake in the Montgomery Lands and their successful exploitation was several times greater than that of Appellants. The dynamics of the contract, therefore, were such that Appellants were not confined to Appellees' implied obligation of good faith. Appellees' own self-interest could only be served by speedy and thorough exploitation of the Montgomery Lands, consistent with sound business judgment which the agreement was designed to give them the right to exercise, and which Appellants would deny them.

B. Performance of a Contract Which Cannot Be Anticipatorily Breached May Not Be Accelerated in the Absence of an Acceleration Clause.

The only point made at pages 30-31 of Appellees' Brief was that assuming Appellants overcame all of the obstacles to their contentions, they would then have a contract within and governed by the limitations prescribed in the authorities cited at page 31 of Appellees' Brief. Performance of such an agreement may not be accelerated without an acceleration clause. This is clear from *Flynn & Treacy v. Mowry,* 131 Cal. 481 (1901), where the following appears at page 486:

> "There can be no rescission or abandonment of a contract by a party who has fully performed his part of it. The obligation of the other party is measured by the terms of his agreement to the same extent as in any other contract. If this obligation is for the payment of money, and by his agreement such payment is to be made in instalments, a failure to pay the first instalment will no more give a right of action to recover them

all than in the case of an ordinary promissory note which is made payable in periodic instalments, and in which there is no provision for the maturity of the whole amount upon the failure to pay one of the instalments."

II.

ABSENT A SHOWING OF PERFORMANCE OF THE CONDITION TO LIABILITY, THERE WAS NO OBLIGATION TO CONSTRUCT OR INSTALL THE RESERVOIR AND PIPELINES.

A. The Condition Was a Condition Precedent.

That section 3 of Exhibit 1 in evidence created a condition precedent the occurrence of which Appellants were obliged to plead and prove [and which, indeed, they did plead, *e.g.,* Clk. Tr. p. 29, lines 26-30] has, we believe, been amply demonstrated at pages 42-50 of Appellees' Brief.

Appellants to the contrary notwithstanding (Reply Br. p. 15, lines 27-29), however, Appellees do not say that Appellants had a right to have the reservoir and pipelines installed and constructed by June 12, 1958, subject to termination if the water was not sufficient. On the contrary, Appellees have consistently taken the position (Appellees' Br. p. 42) that the obligation with reference to the reservoir and pipelines *never came into being* because of the insufficiency of the water. The condition cannot be read to fix the end of an obligation which under the contract never had a beginning. This is quite different from the situation in *Fort Worth Sand & Gravel Co. v. Peters,* 103 S. W. 2d 407 (Tex., Civ. App. 1937), cited by Appellants at pages 16-18 of their Reply Brief. In that case, the

lease assumed the presence of sufficient sand and gravel, and provided, "It is understood . . . that if the sand and gravel on the premises shall become exhausted . . . (lessee) shall be entitled to terminate this lease . . .". (103 S. W. 2d at pp. 408-409.) The reference was clearly to a future event, and was a condition subsequent (*Calif. Civ. Code,* §1438). This must be contrasted with the present case, however, where the contract did not prescribe on what conditions the obligation would end, but rather subject to what conditions it should come into being. Sufficiency of water was a requisite to the accrual of the right, *i.e.,* a condition precedent. (*Calif. Civ. Code,* §1436.)

While we concede the correctness of *Oosten v. Hay Haulers, etc.,* 45 Cal. 2d 784 (1955), and grant that defendant must prove all affirmative defenses, the occurrence of a condition precedent is not a matter of defense, *but a part of plaintiff's cause of action,* and must be proven by the plaintiff. (Please see cases and authorities cited, Appellees' Br. pp. 48-50.)

Appellants argue at pages 18-22 of the Reply Brief that even if the condition were a condition precedent, Appellees had the burden of proving non-occurrence because, they contend, where the circumstances are peculiarly within the knowledge of the defendant, the Court assumes occurrence and shifts the burden. If it be assumed for argument's sake that the "circumstances" were not available to Appellants (who certainly have made no effort to show that they were foreclosed from testing the well), they still must show all facts necessary to Appellees' duty of immediate per-

formance. Professor Corbin, upon whom they rely, does not support them. 3A *Corbin on Contracts,* pages 142 to 143, dealing with equitable defenses, which Appellants cite and paraphrase at page 19 of the Reply Brief, reads as follows:

> "If a fact or event is a condition precedent to a promisor's duty to render the performance promised, its absence or non-occurrence is a 'defense' in an action brought against him for breach of his promise. This is so whether the 'condition' is described as express, implied, or constructive. The use of the word 'defense' often leads to the inference that the burden of alleging and proving the facts constituting the defense rests upon the defendant; the use of the term 'condition precedent' may lead to the opposite inference. But the question whether a certain fact or event is a condition of a promisor's duty, and whether its absence or non-occurrence should be held a good defense, is not identical with the question as to which party must aver and prove its existence or non-existence.
>
> "The burden of allegation, the burden of going forward with the evidence, the burden of persuasion by proof, are not wholly determined by the mere mode of describing it. Other factors are of weight, such as the actual possession of documents, personal participation in the particular transaction, and the fact that access or information is easily available to one, and not to the other. *It is generally true, however, that the burden of alleging and proving a fact on which the plaintiff's remedial rights depends is on the plaintiff; he*

must generally show in his complaint, and prove it if disputed, that all facts necessary to the defendant's duty of immediate performance exist." (Emphasis added.)

In *Stoddard v. Illinois Improvement & Ballast Co.,* 275 Ill. 199, 113 N. E. 913 (1916), cited by Appellants at page 19 of the Reply Brief, defendant was the assignee of the lessee of a quarry under a lease for a term of years "or as long thereafter as the propperty is suitable for quarrying purposes." Defendant, whose assignor had worked the lease successfully for seven years, failed to quarry, and plaintiff sued for damages. Defendant claimed plaintiff had the burden of showing suitability, but the Court held that the burden of showing unsuitability was a matter of defense, the burden being defendant's. On analysis, the case is one where upon the happening of a future event (the property becoming unsuitable for quarrying), an obligation lost its binding effect, or, as defined by section 1438 of the *California Civil Code,* a condition subsequent. The burden of proof thus fell to the defendant. The case is correct, but not in point.

Fleming v. Harrison, 162 F. 2d 789 (8 Cir. 1947), cited by Appellants at page 20 of the Reply Brief, was a treble damage suit under the Emergency Price Control Act of 1942. When defendants failed to deny the applicability of the Act in the answer, plaintiff was held excused from proving it. There was also a stipulation by defendants (162 F. 2d pp. 791-792) which the Appellate Court held *prima facie* established the fact. Accordingly, a directed verdict for defendants was held erroneous.

The cases cited at page 20 of the Reply Brief, *Luttrell v. Columbia Casualty Co.,* 136 Cal. App. 513 (1934), *Kleinpeter v. Castro,* 11 Cal. App. 83 (1909), and *Joost v. Craig,* 131 Cal. 504 (1901), dealing with the quantum of proof which plaintiff must proffer to shift the burden of going forward, are not in point. *Appellants offered no proof.* All three cases, incidentally, were actions on the bonds of notaries public by persons who accepted forged deeds relying on false certificates of acknowledgment. In such cases, whether or not the name of the forger was the same as that of the true owner and known to the notary, were most peculiarly facts within the knowledge of the notary, infinitely more so than in the present case.

Bell v. Pleasant, 145 Cal. 410 (1904) stands simply for the proposition that inasmuch as it is unnecessary in a pleading to anticipate defenses, anticipatory matter will be disregarded, and the burden of proving the defense will continue to rest upon the defendant. But the occurrence of a condition precedent is not defensive. On the contrary, as has been elsewhere demonstrated in this and Appellees' Brief, pleading and proof of the occurrence of conditions precedent to liability are a part of plaintiff's case.

B. There Has Been No Waiver of the Condition Precedent.

Appellants argue that because the reservoir and pipelines were constructed and installed, notwithstanding the insufficiency of the water, Appellees have waived their right to assert the condition. The law is to the contrary.

Professor Corbin states the rule to be as follows (3A *Corbin on Contracts,* §755):

> "The performance of one party may be a condition precedent to the return duty of the other to render a series of performances in instalments. Thus, the conveyance of land by a vendor may be a condition precedent to the duty of the purchaser to make payment of any of a series of instalments of the price that fall due at or after the time set for the conveyance. If the purchaser pays one of these instalments without first receiving the conveyance, he is voluntarily doing that which he is then not bound to do; but he is not waiving or eliminating the condition of his contractual duty. The mere voluntary payment of one or more of these instalments does not make it his duty to pay subsequent instalments without getting the conveyance."

In addition, it is clear in California that where substantive rights are involved, any waiver must be supported by consideration or by acts amounting to an estoppel.

Rennie & Laughlin, Inc. v. Chrysler Corporation, 242 F. 2d 208 (9 Cir. 1957);

Pacific States Corporation v. Hall, 166 F. 2d 668 (9 Cir. 1948);

Peal v. Gulf Red Cedar Co., 15 Cal. App. 2d 196 (1936).

In *Rennie & Laughlin, Inc. v. Chrysler Corporation, supra,* the Court states the rule as follows at page 211:

> "Where substantive rights are involved, it is said frequently that waiver must be supported by either an agreed consideration or by acts amount-

ing to an estoppel. *Peal v. Gulf Red Cedar Co. of California,* 15 Cal. App. 2d 196, 59 P. 2d 183, 184; *Pacific States Corp. v. Hall,* 9 Cir., 166 F. 2d 668. It is undisputed that defendant received no consideration to waive its rights, explicit in the contract, to require that its consent to an assignment be made in writing.

"Only estoppel remains. . . ."

The *Restatement of Contracts* is in accord with the above rule. Section 279 provides as follows:

"A promisor whose duty is dependent upon performance by the other party of a condition or a return promise that is not a material part of the agreed exchange can make that duty independent of such performance, in advance of the time fixed for it by a manifestation of willingness that the duty shall be independent. . . .

"Comment C.

"If performance of the condition is a material part of the agreed exchange, an agreement to be liable in spite of nonperformance of the condition involves to so great a degree a new undertaking that the requisites for the creation of a new contract must exist."

Appellants may not at this late date, without ever having pleaded a waiver, assert a waiver of the condition precedent. Where a party intends to rely upon a waiver, it is necessary that it be pleaded.

Purefoy v. Pacific Automobile Indemnity Exchange, 5 Cal. 2d 81, 91 (1935);

Distributors Packing Co. v. Pacific Indemnity Co., 21 Cal. App. 2d 505, 509 (1937).

In both the *Purefoy* and *Distributors Packing Co.* cases, *supra,* the defendant insurance companies asserted as a defense failure on the part of the plaintiff to give timely notice. The defense was sustained in both cases, notwithstanding the contention that there had been waivers by the companies.

In the *Purefoy* case the Court laid down the following rule at page 91:

> ". . . It is the rule in this state that where the plaintiff relies on waiver of a breach of conditions in a policy, he must allege said waiver, and evidence of waiver is not admissible under allegations of performance of conditions." (Citations.)

The Court in the *Distributors Packing Co.* case summarily dismissed the plaintiff's contention of waiver with the following statement at page 509:

> "The second question is not properly presented for our consideration, for the reason that the law is settled that, where the plaintiff relies on a waiver of a breach of conditions of an insurance policy, such waiver must be alleged and evidence of the waiver is not admissible under an allegation of performance of the conditions of the contract. (*Purefoy v. Pacific Auto. Indem. Exch., supra,* 91.)"

And finally, even if the facts showed a waiver in the context of the cases cited above, Appellants could not rely upon it as a basis for affirmative suit. The doctrine of waiver can be employed as a shield, not as a sword.

In *Rennie & Laughlin, Inc. v. Chrysler Corporation, supra,* at page 210, the rule is stated as follows:

> "The amended complaint purports to ground plaintiff's action on the doctrine of waiver. It avers, 'That having consented to the aforesaid sale to said purchasers, defendant's subsequent revocation of said consent constituted a breach of said sales contracts * * *' If in fact that were the only basis upon which plaintiff could conceivably proceed further discussion would be unnecessary, for it is settled that waiver can be employed only for defensive purposes. It can preclude the assertion of legal rights but it cannot be used to impose legal duties. The shield cannot serve as a sword."

Woodard v. Glenwood Lumber Co., 171 Cal. 513 (1950), relied upon by Appellants, is not in point. In that case the covenant to erect the sawmill read as follows:

> "Said sawmill to be erected and constructed and in working order, ready to commence operations, as soon as there shall be constructed and in operation a railroad from the City of Santa Cruz, crossing Gazos Creek; . . ."

The construction and operation of the railroad fixed the *time* for performance, not the *condition* to performance. In the present case, the obligation did not exist unless there was sufficient water measured by the contractual criteria. In addition, in the *Woodard* case, the plaintiff continued to own the land; in the instant case, title to the land had passed to Appellees, and no rights of Appellants were held in suspense. Finally, the cases are entirely different in terms of the rights asserted and the remedies sought.

La Miller v. St. Claire Packing Co., 99 Cal. App. 2d 518, 521 (1950), also cited by Appellants, is not in point, it standing for the proposition that by failing timely to reject tomatoes for failure to conform to contract, but accepting and converting the tomatoes in its canning process, defendant waived strict performance of the contract. One cannot quarrel with this proposition, nor with the proposition also urged by Appellants at page 25 of the Reply Brief, that waiver may be established by verbal acts. As has been demonstrated, however, there was nothing in the acts and conduct of Appellees from which a waiver could be established.

C. The Claim of Insufficient Water Was Made in Good Faith.

A complete answer to Appellants' argument as to the lack of good faith in the assertion of insufficient water lies in the agreement itself. Appellants to the contrary notwithstanding, nothing required Appellees to satisfy themselves as to sufficiency in the interim between the first and second agreements. Nothing required that they return the wells if they were dissatisfied. This was a matter of option. While the Trial Judge made the statement attributed to him, it was premised upon an incorrect reading of the contract, and a faulty understanding of the facts. It is precisely the Trial Court's reasoning, and the conclusion reached from it, which gives rise to the cross-appeal, and it is respectfully submitted that the issue must be resolved not in terms of what the Trial Court did, but rather what it should have done.

III.

THE ORDER REFUSING TO STAY PROCEEDINGS PENDING ARBITRATION WAS IMPROPER.

A. There Is Jurisdiction to Entertain the Appeal.

Appellants contend (Reply Br. pp. 27-28) that the Court of Appeals is without jurisdiction at this time to entertain an appeal from the order denying the application for a stay of proceedings pending arbitration. They reason that since the order was an appealable interlocutory order, a failure to appeal at the time of the order constitutes a waiver of the right of appeal. This is not the law.

> *Bingham Pump Co. v. Edwards,* 118 F. 2d 338, 339 (C. C. A. 9, 1941);
>
> *Lawyers Trust Co. v. W. G. Maguire & Co., Inc.,* 2 F. R. D. 310, 312-313 (D.C. Del. (1942);
>
> *Jones Bros. Co. v. Underkoffler,* 24 Fed. Supp. 393 (D. C. Pa. 1938).

The rule appears to be well established that where an interlocutory order is made appealable under Title 28, U. S. C. section 1292, the party aggrieved has the right to appeal from the interlocutory order, but if he does not, this is no waiver of the right to complain of the order in an appeal from the final judgment.

Thus, in *Jones Bros. Co. v. Underkoffler, supra,* at pages 393-394, the following appears:

> "Section 129, supra, does not divest this court of jurisdiction to reconsider questions passed upon by an interlocutory decree before entering a final order. Section 129 grants the privilege or option

to take an appeal from an interlocutory decree granting an injunction. Failure to exercise this option by taking a preliminary appeal, however, in no way affects the right to have the court reconsider the interlocutory order before entering a final decree, or the right to appeal from the final decree. Marden v. Campbell Printing Press, etc., 1 Cir., 67 F. 809; Ex Parte National Enameling & Stamping Co., 201 U.S. 156, 26 S.Ct. 404, 50 L.Ed. 707."

The Ninth Circuit passed upon the question in *Bingham Pump Co. v. Edwards, supra,* holding to the same effect, in the following terms (*supra,* 118 F. 2d at page 339):

"With respect to the suggestion that the question as to the validity of the patent is not open because of a failure to appeal from the interlocutory decree as permitted by 28 U.S.C.A. § 227a, we think the same rule is applicable to that section as is applicable to § 227, and that therefore appellant was not required to appeal from the interlocutory decree. Victor Talking Mach. Co. v. George, 3 Cir., 105 F.2d 697, 699."

B. Appellees Were Not in Default in Proceeding With Arbitration.

While it is true that the original complaint was filed on October 8, 1958, the amended complaint was filed June 17, 1959 [Clk. Tr. p. 17], and on June 30, 1959 a motion to stay pending arbitration was filed. [Clk. Tr. pp. 54-55.] The arbitration issue was urged at every opportunity. [Clk. Tr. pp. 54-55, 62-63, 77-78, 84-86, 201-202, 211-212.]

We do not quarrel with Appellants' position that the stay provided in title 9, U. S. C., section 3, is not available to an applicant who is in default in proceeding with arbitration, but it is difficult to see how default in proceeding can be asserted against Appellees, who, on so many occasions, moved the Court for a stay of proceedings pending arbitration.

The case is quite different from *Radiator Specialty Co. v. Cannon Mills,* 97 F. 2d 318, 319 (C. C. A. 4 1938), cited by Appellants at page 33 of the Reply Brief, where the motion for a stay was not made *until the day set for trial.* In *American Locomotive Co. v. Gyro Process Co.,* 185 F. 2d 316 (6 Cir. 1950) and *American Locomotive Co. v. Chemical Research Corp.,* 171 F. 2d 115 (6 Cir. 1949), the Court emphasized that a seven-year delay in proceeding to arbitration was "unreasonable and unexcusable under all the circumstances, and constituted 'default' on its part in proceeding with arbitration." (171 F. 2d p. 21.) Both *American Locomotive Co.* cases are infinitely removed from the facts of the instant case.

Closer to the point, it is respectfully submitted, is *Kulukundis Shipping Co. v. Amtorg Trading Corp.,* 126 F. 2d 978, 989 (2 Cir. 1942), where the Court stated as follows:

> "We take that proviso to refer to a party who, when requested, has refused to go to arbitration or who has refused to proceed with the hearing before the arbitrators once it has commenced. The

> appellant was never asked by appellee to proceed with the arbitration; indeed, it is the appellee who has objected to it. In *Shanferoke Coal & Supply Corp. v. Westchester S. Corp.,* 2 Cir. 1934, 70 F. 2d 297, plaintiff alleged that defendant, after part performance, materially breached the contract. The defendant in its answer denied the allegations and, as a special defense, set up an arbitration clause in the contract, alleged that it was willing to arbitrate, and moved for a stay under Section 3 of the Arbitration Act. Answering plaintiff's contention that defendant was 'in default in proceeding with such arbitration,' we held that the fact that defendant may have breached the contract was not a 'default' within that statutory provision; we said that the initiative as to proceeding with the arbitration rested upon plaintiff, adding: 'If it did not but sued instead, it was itself the party who fell "in default in proceeding with such arbitration," not the defendant.' Our decision was affirmed in *Shanferoke Co. v. Westchester Co.,* 1935, 293 U. S. 449, 55 S. Ct. 313, 79 L. Ed. 583."

Also of significance is *Almacenes Fernande, S.A. v. Golodetz, et al.,* 148 F. 2d 625, 628 (2 Cir. 1945). where the following appears:

> "However, delay in moving for an arbitration order will not alone amount to a default within the proviso."

To the same effect is *Robert Lawrence Company v. Devonshire Fabrics, Inc.,* 271 F. 2d 402, 412-413 (2 Cir. 1959).

C. The Stay Should Have Been Granted.

1. The Agreement Evidences a Transaction Involving Commerce.

It is submitted that Appellants have failed to meet the cases and authorities cited at pages 50-55 of Appellees' Brief. These are believed to be controlling. However, meeting Appellants on their own ground, it is to be noted that the applicability of Title 9, U. S. C., is not restricted to contracts *in* commerce, but rather to contracts evidencing transactions *involving* commerce. By definition, the concept of involvement is broad. As was said in *Culver v. Kurn,* 354 Mo. 1158, 1163, 193 S. W. 2d 602, 604 (1946): "'Involve' imports the idea of 'implicate,' 'include,' 'affect.'" Recent cases dealing with the clause "involving commerce," as used in Title 9, U. S. C. §2, indicate the trend toward a broad view of commerce. Please compare:

In re Cold Metal Process Co., 9 Fed. Supp. 992 (W. D. Pa. 1935); with

Petition of Prouvost Lefebvre, etc., 105 Fed. Supp. 757 (S. D. N. Y. 1952); and

Wilson & Co. v. Fremont Cake & Meal Co., 77 Fed. Supp. 364, 373 (D. Neb. 1948).

In *Petition of Prouvost Lefebvre, etc., supra,* the respondent contended that the contract there concerned did not evidence a transaction involving commerce, because the shipments to be the subject of the arbitration were wholly intrastate. The Court held that because the contract evidenced a transaction between persons in different states (the identical situation before the Court in the instant case), and because instructions for the

wholly intrastate transaction were through the mails, the transaction involved commerce. The arbitration was ordered.

2. **There Is an Arbitrable Issue Before the Court.**

Appellants' argument to the general effect that there is no arbitrable issue (Reply Br. pp. 30-31) is premised necessarily upon their assumption that the condition precedent has been waived. Manifestly, if there was no waiver of the condition precedent, the issue of sufficiency remained in the case and under the terms of the agreement was arbitrable. The Court's attention is invited to section II B of this brief which, we believe, demonstrates that the condition precedent has not been waived.

It is respectfully submitted that the arbitrable issue exists by reason of the following:

(a) The contract contemplates that an arbitrable controversy as to water may arise [Clk. Tr. pp. 46-47];

(b) The amended complaint tenders the issue as to whether the wells are physically able to produce sufficient water [Clk. Tr. pp. 28-29];

(c) The answers filed on behalf of the Appellees accept the tender and create the issue as to the sufficiency of water [Clk. Tr. pp. 72, 154].

Under the circumstances, and in the absence of a waiver (which Appellants did not believe existed at the time of the filing of the first amended complaint), it is difficult to see how they can contend that the matter of the sufficiency of the water was not an issue in the case.

3. Arbitration Should Have Been Ordered by the District Court.

Appellants concede that the contract was to be performed "for the most part" in California, but was "at least partially executed and performed in Texas." (Reply Br. p. 34.) We think it clear that a contract to be performed partially in one state and partially in another, contemplating the building of many structures, and necessarily the interstate shipment of materials in connection therewith, involves commerce in the sense of Title 9, U. S. C.

In this connection, the Court's attention is invited to the case of *Ross v. Twentieth Century-Fox Film Corporation,* 236 F. 2d 632 (9 Cir. 1956), where the contract concerned was solely and exclusively for the sale of motion picture rights to a literary property entitled "The Robe." The purchase price was to be determined by the net receipts of the motion picture based on the work. The contract was made in California, and the transfer of the literary rights provided therein was effected in California. The Ninth Circuit held that since the contract called for the production of a motion picture for national sale and distribution, and because that provision was no minor nor incidental aspect of the bargain, the contract was one evidencing a transaction in commerce, and that the stay provided in Title 9, U. S. C. §3 should be granted.

The instant case is stronger on its facts than *Ross v. Twentieth Century-Fox Film Corporation, supra.*

We believe Appellants misunderstand the holding of *Bernhardt v. Polygraphic Co. of America,* 350 U. S. 198, 76 S. Ct. 273 (1956) when they state that the

case stands for the proposition that the right to arbitrate does not owe its existence to Federal law. The holding of the *Bernhardt* case is that absent a contract within the ambit of Title 9, U. S. C. §2, the substantive right to arbitration is to be determined by state law. But it is quite clear from *Robert Lawrence Company v. Devonshire Fabrics, Inc.,* 271 F. 2d 402, 407-410 (2 Cir. 1959) that by its enactment of the United States Arbitration Act the creation of a body of Federal substantive law was intended by Congress. In that connection, Judge Medina stated, *supra,* at page 406, the following:

> "We think it reasonably clear that the Congress intended by the Arbitration Act to create a new body of Federal substantive law affecting the validity and interpretation of arbitration agreements . . ."

Accordingly, Appellants' assertion that the Federal Court "only enforces the state created right by rules of procedure, required by the Federal Act, not necessarily the same as state procedure," is wholly without support.

In addition, as noted in Appellees' Brief at page 53, the question of whether or not an agreement contains a valid arbitration clause is a question of procedure, determinable by Federal and not local law, and therefore, as pointed out, the conflicts problem which Appellants raise at page 34 of the Reply Brief does not really exist.

At page 38 of the Reply Brief, Appellants suggest that *Robert Lawrence Company v. Devonshire Fabrics, Inc., supra,* is some kind of unique judicial aberration.

That it is not, we believe, is quite clear from *Metro. Industrial Painting Corp. v. Terminal Construction Co.,* 181 Fed. Supp. 130, 133 (D. C. S. D. N. Y. 1950), and *Rosenthal-Block China Corporation,* 183 Fed. Supp. 659, 661 (D. C. S. D. N. Y. 1960), where the Court quotes with approval the language of Judge Medina hereinabove set forth.

Appellants then go on to argue, if we understand them correctly, that if we assume that the contract here in question does not evidence a transaction involving interstate commerce, that the law of Texas with respect to arbitration applies. In *2 Beale, Conflict of Laws,* page 1245, the following appears:

> "American courts, without exception, hold that arbitration agreements pertain to remedy or procedure. Consequently, *the law of the forum determines their enforceability, regardless of the place where the contract containing an arbitration provision was made, or was to be performed, or the law intended by the parties to govern* . . . Following the remedy rule the Federal Courts apply their own, and not the state court-common-law or statute with regard to arbitration. The English cases uniformly hold arbitration substantive, with results contrary to those set forth above." (emphasis added.)

Professor Beale cites a wealth of cases for the proposition that arbitration is procedural and goes to remedy, rather than substantive right, and in the context of the *Erie Railroad* doctrine we respectfully submit that in this area, and assuming that Title 9, U. S. C. is for some reason inapplicable, the Court would look

to the California law with respect to the arbitration clause, and not to the Texas law.

In *Crofoot v. Blair Holdings Corp.,* 119 Cal. App. 2d 156, 193 (S. Ct. hearing denied 1953), the District Court of Appeal of the State of California stated the proposition that "it is, of course, the law that in the absence of agreement to the contrary the law of the forum governs arbitration proceedings . . .".

Appellants to the contrary notwithstanding, we believe it clear that sections 1280 and 1284 of the Code of Civil Procedure of the State of California means what they say in declaring arbitration agreements to be valid. Granted that it is not an absolute right, and that the statement in *Local 659, I. A. T. S. E. v. Color Corp. of America,* 47 Cal. 2d 189, 194 (1956) is correct, Appellants have not revoked the contract, and indeed are proceeding in reliance upon the contract.

Conclusion.

It is respectfully submitted that Appellants have had their day in court. If they are dissatisfied with what they were awarded, the error was not that of the Trial Court, but rather their own in asking for more than they were entitled to.

Insofar as possible, we have attempted to confine this brief to the Cross-Appeal. As we noted in Appellees' Brief, the Cross-Appeal was taken and the points raised in order to bring the three errors to the attention of the Court of Appeals so that they should not become the law of the case in the event of reversal by reason of Appellants' appeal. We repeat our willingness, however, to accept a dismissal of the Cross-Appeal notwithstand-

ing the three errors noted therein, should the Court of Appeals conclude that Appellants' appeal is not well taken.

Accordingly, the judgment of the District Court should be affirmed.

Respectfully submitted,

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Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that in my opinion the foregoing brief is in full compliance with those rules.

STUART L. KADISON

No. 18198

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

STEPHAN RIESS and THELMA MCKINNEY RIESS,

Appellants and Cross-Appellees,

vs.

C. W. MURCHISON and SIMI VALLEY DEVELOPMENT COMPANY,

Appellees and Cross-Appellants.

Appellants and Cross-Appellees' Consolidated Reply Brief on Appeal and Brief on Cross-Appeal.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

CASES PAGE

PAGE

PAGE

RULES PAGE

STATUTES

TEXTBOOKS

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INTRODUCTORY STATEMENT.

In the introductory portions of their brief, Appellees-Cross-Appellants (hereinafter referred to as "Appellees") make certain statements that require a brief response.

First, it should be noted that Appellees characterize their position, insofar as the application of the doctrine of breach by anticipatory repudiation is concerned, in the following language:

> "In brief, our position is that the Trial Court was correct in holding, as a matter of law, that the contract was not susceptible to the application of the doctrine of breach by anticipatory repudiation . . ." (Appellees' Br. p. 1).

As we have previously noted at some length, a holding to this effect would be contrary to the applicable state law (Appellants' Op. Br. Point I, pp. 20-53). More pertinently, however, the Trial Court did *not* so hold: rather, it adopted findings, prepared by Appellees, to the effect that Appellees had not repudiated their contract, and concluded from this that no anticipatory breach had occurred. Thus, the decision below rested, not on the legal ground presently advocated by Appellees, but rather on the factual basis advocated by them in the Trial Court. As we have indicated, the latter basis is equally indefensible (Appellants' Op. Br. Point II, pp. 64-71).

Second, Appellees are incorrect in their contention that the burden of showing the occurrence of a condition to their obligations was upon Appellants; the burden, under the contract in question and the circumstances of this case, was clearly upon Appellees (Point II, *infra*).

Third, Appellees appear to suggest (Appellees' Br. pp. 1-6, 7-8) that once payment of the down payment and sums required to be paid during the first two years following the consummation of the agreement had been made, the contract was in the nature of a lease calling for royalty payments, with payments dependent solely upon production. While the situation is to a limited extent analogous, the analogy may not be carried as far as Appellees seek to carry it. Appellants have delivered fee title to their properties, and can no longer claim any present right, title or interest or any right to a remainder or reversionary interest. The purchase price to which they are entitled under the agreement

is one million dollars; and while the rate at which payment is to be made is dependent upon production the right to ultimate payment of the entire amount is fixed.[1] Thus, the statement made by Appellees at page 8, that after the first two year period Appellants had the option to take water at the well head at the specified rate, or nothing, and elected to take nothing, is manifestly incorrect. Appellants' option was to take water at the well head in payment of a portion of the purchase price, or to wait until subsequent years and take payment in cash. The failure to exercise the option only delayed the payment, and in no way operated to discharge it. Furthermore, by the time the right to exercise the option matured for the first time, Appellees were in breach, Appellants had elected to treat the breach as an anticipatory breach, and an election to take water could well have operated as a waiver of substantial rights by Appellants.

Fourth, the suggestion that the jury was dismissed on the agreement and stipulation of the parties (Appellees' Br. p. 9), while technically correct, is misleading. As Appellees properly point out, the trial judge ruled that no issue of fact remained for jury determination. The trial judge rejected the suggestion of Appellants that the proper procedure would be to instruct the jury in accordance with the judg's legal rulings, and left Appellants no alternative other than to consent to the discharge of the jury. Manifestly, no one anticipated that the trial judge, having already indicated

[1]Of course, any further obligation on Appellees' part may be terminated by reconveyance of the water lands to Appellants, but Appellees have apparently disabled themselves from making such reconveyance [Clk. Tr. p. 281].

his rulings and his reasons therefor, would proceed to adopt findings, conclusions, and a judgment based upon those very matters he had ruled immaterial. It is not the discharge of the jury, in itself, that is objected to; it is rather the reversal of position, on the part of the trial court, that ultimately resulted in the entry of a judgment expressly based upon findings of fact which invade the province of the jury.

I.

THE DOCTRINE OF TOTAL BREACH OR BREACH OF CONTRACT BY ANTICIPATORY REPUDIATION IS APPLICABLE TO THE AGREEMENT IN THE CASE AT BAR.

A. The Rule of Law to the Effect That Unconditional Unilateral Contracts for the Payment of Money in Installments Are Not the Proper Subjects for the Doctrine of Anticipatory Breach Is Not Applicable.

As was to be expected Appellees have relied heavily on the line of cases which support the proposition that the doctrine of anticipatory breach is not applicable to certain types of contracts for the payment of money.

The cases relied on by Appellees represent the majority view as expressed by this Court and the California Supreme Court and we do not quarrel with it. However, Appellees in their attempt to demonstrate that the rule is applicable to the case at bar are forcing an extension of it to a type of contract not involved in the cases on which they rely and are thereby attributing to it a far reaching effect not intended or contemplated by the courts. We suggest that if indeed any modifications of the rule were to be made the courts would be

more inclined toward a restriction on its scope along the lines suggested in the cases expressing the minority view or the observations of Professor Corbin on the subject.

Placid Oil Company v. Humphrey, 244 F. 2d 184 (5th Cir. 1957);

4 Corbin on Contracts, §962 ff, p. 864 ff.

The language employed by the courts indicates that the rule is precise and, by its terms as well as its application, limited to a very narrow field of contracts. It is concerned with a particular type of agreement such as an insurance contract, a promissory note or a lease. This Court in *John Hancock Mutual Life Ins. Co. v. Cohen,* 254 F. 2d 417 (9th Cir. 1958) defined the rule as follows:

> "We conclude the general rule to be that the doctrine of anticipatory breach has *no application to suits to enforce contracts for future payment of money only, in installments or otherwise.* Cobb v. Pacific Mutual, supra; Flinn v. Mowry, supra; Brix v. People's Mutual Life Ins. Co., supra; Sulyok v. Penzintezeti, 279 App. Div. 528, 111 N. Y. S. 2d 75, 82; 105 A.L.R. 460; Restatement, Contracts, §§ 316-318; 5 Williston, Contracts, 3740 - 3743; 12 Cal. Jur. 2d, Contracts §§ 246-250; see also 24 Calif. L. Rev. 216." (emphasis added) (254 F. 2d at 426).
>
> ". . . But we find no indication in either the law of New Mexico or of California of an intent to depart from the majority view that *uncondi-*

tional unilateral contracts for the payment of money in installments are not the proper subjects for the doctrine of anticipatory breach." (emphasis added) (254 F. 2d at 426-427).

If the rule, as defined in the *John Hancock* case, is applied to the agreement in the case at bar the conclusion is inescapable that this agreement does not come within its terms.

1. The Agreement Is Not Unconditional.

Appellees themselves acknowledge the agreement to be conditional for they assert that their obligation to construct and install the pipelines and reservoir by June 12, 1958, was conditioned on there being sufficient water and they further claim that the water was not sufficient, thus excusing their performance. Appellees conclude "there can be no repudiation through failure to perform a conditional obligation when the condition has not been met, . . ." citing *Clarey v. Security Portland Cement Co. Inc.,* 99 Cal. App. 783 (1929) (Appellees' Br. p. 19). We are unable to discover any language in the *Clarey* opinion in support of this proposition, but regardless of whether or not it is a correct statement of the law it is in any event inapplicable because by failing to construct and install the reservoir and pipelines prior to June 12, 1958, and prior to the time this lawsuit was commenced, Appellees thereby placed it out of their power to go forward with the development of the Montgomery lands for residential and industrial purposes as contemplated by the agreement, and thus rendered meaningless their implicit undertaking to produce, save and sell water and their express obligation to make payment therefor to Appellants. This is precisely the type of

situation in which the doctrines of anticipatory breach or total breach are said to be applicable.

Wolf v. Marsh, 54 Cal. 228 (1880);

Grant v. Warren, 31 Cal. App. 453, 160 Pac. 847 (1916);

Restatement of Contracts, §317, Comment (b).

Since Appellees make much of their argument that the agreement was conditional (Appellees' Br. pp. 42-50) it is difficult to ascertain how they can at the same time insist that the limiting rule which is applicable only to *unconditional* contracts can be invoked.

2. The Agreement Remained Bilateral.

This point has heretofore been discussed in some detail in Appellants' Opening Brief, pages 26-28, wherein the several covenants and duties, express and implied which remained unperformed are set forth. A further example of its bilateral nature, and one not previously referred to is found in Paragraph (h) of the agreement, wherein it is provided that Appellees at their election, if they determined the water to be insufficient, could reconvey the wells to Appellants and further provided that Appellants would then be obligated to accept them and to relieve Appellees from any further obligations under the agreement. The informative discussion on this entire subject of anticipatory breach and the limiting rule found in the dissenting opinion in *Federal Life Ins. Co. v. Rasco,* 12 F. 2d 693, 695-696 (6th Cir. 1926), contains a comment on the meaning of the term "executory" or "bilateral" as it relates to the application of the restricting rule. It was there observed that a contract is deemed to be executory as against plaintiff if it requires him to do something so that an

action may lie against him for specific performance or for non-performance if he fails to perform. So, applying this test to the case at bar, undoubtedly Appellees could have brought an action against Appellant Stephen Riess if he had refused to locate additional wells as required by Paragraph (c) of the agreement; or an action for specific performance could have been brought by Appellees based on Appellants' alleged refusal to arbitrate.

By their argument to the effect that Appellants in the absence of cash payments were obligated to demand payment in kind, *i.e.*, water (assuming for the moment that the argument has any merit) Appellees themselves call attention to yet another provision of the agreement which remained executory and unperformed (Appellees' Br. pp. 27-28). Furthermore, by retaining the wells and refusing to construct the water system prior to June 12, 1958, Appellees as a result were in breach of their covenant of good faith and fair dealing and their obligation to diligently go forward with the objects and purposes of the agreement which the law under these circumstances will imply.

Winegar v. Gray, 204 Adv. Cal. App. 332, 22 Cal. Rptr. 301 (1962).

3. The Agreement Is Not a Simple Contract for the Payment of Money in Installments.

Appellees have devoted considerable energy to an explanation as to why the agreement must necessarily be found to be one for the payment of money in installments (Appellees' Br. pp. 12-24). We concede that in part the agreement most certainly did call for the payment of money in installments in undetermined amounts

measured by the quantities of water produced, saved and sold. But it also required the performance by Appellees of certain acts. The most important of these acts, from the Appellants' standpoint, was the construction and installation of the pipelines and reservoir prior to June 12, 1958. In addition, Paragraph 5 of the agreement required Appellees to perform other acts. Appellees, however, with equal enthusiasm have asserted that the agreement does not call for payment of money in installments but rather that it imposes an obligation to pay in kind (Appellees' Br. pp. 27-30). This argument, we submit, is self defeating since the very rule which Appellees seek to invoke is limited solely to contracts requiring the payment of money in installments.

4. The Restricting Rule Is Not Applicable to Indivisible Contracts Calling for Performance of Connected Acts.

It is immaterial really whether the agreement is found to be bilateral or unilateral, conditional or unconditional, or whether in other respects it meets the test set forth in the *John Hancock* case, because the California Supreme Court has held that in any event the restrictive rule *does not apply where the acts to be performed by the promisor are connected with one another and the thing to be accomplished by the contract is total.*

Gold Mining & Water Co. v. Swinerton, 23 Cal. 2d 19, 29-30, 142 P. 2d 22 (1943);

Restatement of Contracts, §316.

Although a detailed analysis of the agreement demonstrating its indivisibility and elaborating on the ways in which the various acts and obligations were interconnected has previously been made (Appellants' Op. Br. pp. 36-37, 41-42), a further examination seems in

order in view of the importance of the point. We have observed that pursuant to the provisions of this agreement Appellees purchased the water wells from Appellants to provide water for the Montgomery lands which they proposed to develop for residential and industrial purposes. A portion of the purchase price was paid to Appellants but by far the greater part of it was to be paid over a period of time in amounts to be determined by the quantity of water produced, saved and sold. Water could be produced, saved and sold only if a water system were constructed to convey the water from the wells to the Montgomery land and Appellees agreed to construct that water system within two years from the date of consummation of the purchase (June 12, 1956). By entering into this bargain Appellants thereby gave up all their right, title and interest to the water wells and Appellees thereafter were in complete control thereof and they alone had the power to determine their fate. The only express protection Appellants had to assure payment of the unpaid balance of the purchase price was the provision requiring Appellees to construct the water system, the existence of which would enable the water from the wells to be marketed. The only other protection which Appellants had was the implied obligation of good faith on the part of Appellees to go forward diligently with the development of the Montgomery land and to carry out the purposes of the agreement to the end that water could be produced, saved and sold and payment made therefor to Appellants. On the other hand, in the event any question developed concerning sufficiency of the water wells, Appellees had ample protection because they had the right to relieve themselves of all obligations under the agreement at any time by

reconveying the wells to Appellants. Appellees did not construct the water system prior to June 12, 1958, subsequently claiming excuse because of insufficiency of water. However, they did not exercise their right to reconvey the wells so as to be relieved of their obligations under the agreement. On the contrary, to this day they have retained the water wells (which they claim to be insufficient), have constructed the water system (which they say they were excused from constructing), and have used the "insufficient" water over a period of years for a variety of purposes, all without any payment to Appellants since September, 1957. The conclusion to be drawn, we believe, is that this was indeed an indivisible contract requiring the performace of interrelated acts and the type of agreement which the courts have uniformly found to be subject to the doctrine of anticipatory breach.

B. The Proposition That an Obligation to Be Performed in Installments Cannot Be Accelerated in the Absence of an Acceleration Clause Is Not Supported by the Authorities.

Appellees have asserted as a bare legal proposition that an obligation to be performed in installments cannot be accelerated in the absence of an acceleration clause (Appellees' Br. pp. 30-31). This contention finds no support whatever in the authorities cited by Appellees and certainly the law applicable, as expressed by the leading cases in which the doctrine of anticipatory breach has been invoked, is directly contrary. For example, in *Gold Mining & Water Co. v. Swinerton, supra,* where the contract in question was a ten year mining lease with payments therefor to be made in in-

stallments and in amounts which were to be determined by production from the mine, the court stated as follows:

> ". . . Clearly, the lease contemplated the continuous extraction of minerals by lessees as one entire obligation. *The mere fact that the royalties were payable monthly and that 300,000 cubic yards were to be worked annually* carries no implication that each payment of royalties was severable from the other, or that each year's output of 300,000 cubic yards was severable from every other year. Rather the one was merely a specification of the time for paying whatever the royalties there might be and the other a minimum below which the output should not fall. *It is not like the case of money payable in fixed installments.*" (emphasis supplied) (23 Cal. 2d at 29-30).

See also:

Coughlin v. Blair, 41 Cal. 2d 587, 262 P. 2d 305 (1953);

Grant v. Warren, 31 Cal. App. 453, 160 Pac. 847 (1916);

Love v. Mabury, 59 Cal. 484 (1881).

Appellees could only justify such a conclusion if they assumed not only that the agreement fell within that narrow field of contracts which are unilateral, unconditional and require only the payment of money in installments, but also that it was not an indivisible contract calling for the performance of interrelated acts, and that they had not at the time of the breach placed it out of their power to perform as to a substantial part.

C. At No Time Have Appellants Sought to Convert the Agreement to an Obligation to Pay in Kind or to in Any Way Rewrite It.

Appellees, as we have seen, insist that the bargain was limited to the right of Appellants to receive and to the obligation on Appellees' part to pay monies in installments in amounts determined by quantities of water produced, saved and sold and therefore the doctrine of anticipatory breach is not applicable under the restriction laid down in the *John Hancock* and related cases (Appellees' Br. pp. 12-24). That there is no support for this contention to be found in the language of the agreement has hereinabove been demonstrated under subheading A. Yet when it suits them Appellees argue that Appellants' bargain was limited to their right to receive and an obligation on Appellees' part to pay the balance of the consideration in kind (Appellees' Br. pp. 27-28) and that Appellants, having waived the right to demand payment in kind, could not in any event invoke the doctrine of anticipatory breach. This argument, however, completely loses sight of the fact that under Paragraph 2(b) of the agreement the earliest moment that Appellants could have given notice demanding payment in kind, assuming they elected to exercise this right, was thirty days after June 12, 1959, the end of the first accounting year. Appellants by commencing this action for anticipatory breach in October, 1958 thereby made final their election to treat the agreement as terminated and any demand for payment in

kind thereafter would have been totally inconsistent with this election. Moreover, such action by Appellants might then have been treated as a waiver or an estoppel so as to preclude Appellants from successfully asserting the doctrine of anticipatory breach. The argument completely overlooks the fact that an integral part of the consideration of this agreement was the obligation imposed on Appellees to construct and install the reservoir and pipelines, that Appellees were already in breach of their obligation to pay the balance of the $48,000.00 owed for the first two year period, and that Appellees had stated they would not perform in accordance with the terms of the agreement. Upon the failure of Appellees to perform that obligation to construct and install, the breach then became a total breach and was so treated by Appellants. Under these circumstances the law treats the promise as absolute and unconditional and holds the promisor to the obligation to pay the balance in cash.

Grant v. Warren, supra;
Coughlin v. Blair, supra;
Gold Mining & Water Co. v. Swinerton, supra.

Thereafter, if the injured party elects to bring suit for total breach or breach by anticipatory repudiation, as in the instant case, the contract ceases to exist for all purposes except to determine damages.

Winegar v. Gray, supra;
Coughlin v. Blair, supra;
Alder v. Drudis, 30 Cal. 2d 372, 182 P. 2d 195 (1947).

II.

THE CONTENTION THAT APPELLEES WERE NOT OBLIGATED TO CONSTRUCT OR INSTALL A RESERVOIR AND PIPELINES OR THAT THEY WERE EXCUSED FROM PERFORMANCE IS NOT SUPPORTED BY THE FACTS OR THE APPLICABLE LAW.

A. The Question of Sufficiency of Water, if It Was a Condition at All, Was a Condition Subsequent.

The Appellants have alleged that the wells now located on the water lands were physically able to produce sufficient quantities of water so as to adequately service the Montgomery lands and that the water lands were capable of commercially producing many millions of gallons. The Appellees have denied these allegations and have affirmatively asserted that the wells were not capable of commercially producing many millions of gallons, that they were not sufficient to service the Montgomery lands, and that they were not sufficient to supply water to more than 200 acres [Clk. Tr. pp. 24, 28-29, 71, 74, 153, 154, 156, 158]. The question of sufficiency, Appellants maintain, is related to facts which are such that, if it can be said that any condition is created at all, give rise to a condition subsequent which is a matter of proof for Appellees.

The agreement gave Appellants the right to have the pipelines and reservoir installed and constructed by the Appellees prior to June 12, 1958. That right was subject to termination, say Appellees, if the water was insufficient to service the Montgomery land. Since it is true that a condition precedent fixes the beginning of a right while a condition subsequent fixes the end, it is clear that the question of sufficiency in this instance

could only be a condition subsequent. Stated differently, the contract imposed on the Appellees the obligation to construct and install the pipelines and reservoir prior to June 12, 1958, and the contract provided further that Appellees might be relieved of their obligation if there was insufficient water. This factual situation then falls precisely within the definition of a condition subsequent as set forth in the California Civil Code:

> "§1438. *Condition subsequent.* A condition subsequent is one referring to a future event, upon the happening of which the obligation becomes no longer binding upon the other party, if he chooses to avail himself of the condition."

Since the provision excusing performance by the Appellees is solely for their benefit and is subject to their discretion to invoke it, should that condition fail to occur it is, as a consequence, a matter to be relied upon by way of defense and the burden of proof necessarily must fall on the Appellees to establish its occurence. A case directly in point under circumstances nearly identical with those in the instant case, holding that sufficiency, or lack of it, is a matter to be established by a preponderance of the evidence by defendants is *Fort Worth Sand & Gravel Co. v. Peters,* 103 S. W. 2d 407 (Tex. Civ. App. 1937). There plaintiff as lessor entered into a lease with defendant in July, 1928, whereby he leased 40 acres of land, along with the exclusive use of a certain railroad track and ingress and egress rights. Defendant agreed to pay plaintiff a royalty of 10 cents per cubic yard for all gravel and sand taken from the premises and further agreed if it did not take enough sand and gravel during a month so that royal-

ties equalled $200 it would pay that amount as a minimum, provided, that if the $200 exceeded the amount due lessor based on yardage removed lessor thereafter and before expiration of the lease could remove sand and gravel to the extent of that excess. The lease provided further that if sand and gravel became exhausted or the quality was such that it could not be mined with reasonable profit then on 30 days notice defendant might terminate the lease. The lessee took possession under the lease and made monthly payments until May, 1930, when it gave notice of termination. Plaintiff sued for $2,700, the minimum royalty promised for the unexpired term. Defendant claimed it entered into the lease believing there to be sufficient sand and gravel of good quality and that the parties made a mutual mistake as to this; that the consideration failed because of the absence of sand and gravel in sufficient quality and quantity to permit mining at a reasonable profit; that it had expended substantial sums of money in connection with the lease; and that the contract permitted such a termination. Plaintiff claimed that defendant made its own tests to satisfy itself as to quantity and quality; that defendant made no bona fide attempt to mine the sand and gravel prior to breach; that the sand and gravel were of sufficient quality and quantity and could have been mined at reasonable profit. In deciding for plaintiff the court stated that defendant, in order to terminate the lease, must allege and prove the happening of the condition and provisions specified in the contract. If defendant was not justified in terminating the lease then plaintiff was entitled to recover the minimum royalty payments for the remainder of the life of the contract and plaintiff was only re-

quired to prove as to the amount of damages suffered the minimum contracted to be paid under the contract. The court held with respect to the question of quality and sufficiency that since defendant challenged the right of plaintiff to recover by reason of certain exceptions and that by reason of the exceptions there was no liability on defendant and special issues based on such exceptions were submitted to the jury, it was proper to instruct the jury that the burden of proof was on defendant to establish by a preponderance of the evidence that the condition or exception existed.

In *Oosten v. Hay Haulers, etc.*, 45 Cal. 2d 784, 291 P. 2d 17 (1955), the rule is enunciated that where the defendant alleges an affirmative defense to an action for breach of contract such as impossibility, frustration, failure of consideration or other typical affirmative defenses which are not expressly provided for in the contract, the burden of proving the fact constituting the defense is on the defendant. Such a rule would seem by analogy to be as applicable to cases such as the one at bar, where non-occurrence of a condition is the affirmative defense asserted.

B. Assuming Sufficiency of Water Was a Condition Precedent, the Burden of Proof to Establish Non-Occurrence of the Condition Was Nevertheless on Appellees.

Even if it is conceded for the sake of argument that the question of sufficiency did create a condition precedent it is nevertheless well established that in certain instances the existence of a condition precedent will be assumed unless it is disproved by the defendant. For example, there are cases wherein a fact is clearly a con-

dition precedent to the duty of defendant but the circumstances concerning it are particularly within the knowledge of defendant. In such instances the court quite properly has made the assumption that the condition did occur unless the defendant proves that it did not.

Southwest Federal Savings & Loan Ass'n v. Cosmopolitan National Bank, 23 Ill. App. 2d 174, 161 N. E. 2d 697 (1959);

Stoddard v. Illinois Improvement & Ballast Co., 275 Ill. 199, 113 N. E. 913 (1916);

3A Corbin on Contracts, pp. 142-143, 467-468.

Appellees contend that Paragraph 3 of the agreement indicates the promise of the Appellees to construct the water system was conditioned on there being an adequate supply of water and that the failure to construct the water system and proceed with the development of the Montgomery land prior to June 12, 1958, was occasioned by the insufficiency of the water available from the water lands to develop the Montgomery acreage for subdivision and commercial uses. If a fact is a condition precedent to the promisor's duty of performance, its absence or non-occurrence is a defense in an action brough against the promisor for breach of his promise. Nevertheless, the party who must assume the burden of allegation, of going forward with the evidence and of persuasion may be ascertained, not by the nature of the fact or event necessarily, but by other facts or events such as actual possession of documents, personal participation in the transaction, easy access to information available to one party and not the other.

3A Corbin on Contracts, pp. 143, 467-468, 475.

Consequently, even if we view the language in Paragraph 3 in the light most favorable to Appellees' contention that sufficiency was a condition precedent to Appellees' duty to construct, the fact that it may be a condition precedent may alone be insufficient to require Appellants to shoulder the burden of proving the fulfillment of that condition. The cases indicate the weight given to other factors.

For example, in *Fleming v. Harrison,* 162 F. 2d 789 (8th Cir. 1947) the court stated:

> "It has been established as a general rule of evidence that the burden of proof lies on the person who wishes to support his case by a particular fact more peculiarly within his knowledge or of which he is supposed to be cognizant." (162 F. 2d p. 792).

See also:

Selma, Rome etc. Railroad v. United States, 139 U. S. 560, 11 S. Ct. 638, 35 L. Ed. 266 (1891);

Butler v. Nepple, 54 Cal. 2d 589, 354 P. 2d 239 (1960);

3A Corbin on Contracts, p. 73.

To similar effect are the cases which hold that where facts are within the knowledge of the defendant, the plaintiff in order to shift the burden of proof need produce only slight evidence.

Luttrell v. Columbia Casualty Co., 136 Cal. App. 513, 28 P. 2d 1067 (1934);

Kleinpeter v. Castro, 11 Cal. App. 83, 103 Pac. 1090 (1909);

Joost v. Craig, 131 Cal. 504, 63 Pac. 840 (1901).

In our situation, Appellees were in exclusive possession of the water lands and the water wells; they had caused tests of the wells to be made; only they were in possession of knowledge concerning the development plans for the Montgomery lands; only they had knowledge of the amount of water which might be required for that development. It is clear, therefore, that the facts which would be required to establish whether or not the wells could produce sufficient water were peculiarly within Appellees' knowledge. Under such circumstances it would be unfair in the extreme to impose the burden of proving sufficiency of water on the Appellants where it is Appellees who, by reason of their exclusive knowledge of their water requirements, their exclusive possession of the wells and water lands for over six years and their exclusive possession of all information as to the quantities of water produced and the uses to which such water was put during that period, have special knowledge of all of the relevant facts.

Appellees claim further that Appellants were required not only to assume the burden of proving the existence of this condition but to plead the facts demonstrating occurrence of the condition (Appellees' Br. p. 45), and they assert that Appellants have not complied. If the condition were found to be a condition subsequent this would not be the case, but in any event Appellees are inaccurate because Appellants did allege compliance with the condition in the amended complaint [Clk. Tr. pp. 24, 28-29]. The question of who must assume the burden of proof was never reached in the trial due to the ruling of the trial judge that sufficiency of water was not an issue in the case.

These allegations of facts concerning sufficiency of the water found in the Amended Complaint may very well have been unnecessary or superfluous since they could have been and were alleged in defense. But the burden of proof does not shift to Appellants merely because they have made such allegations. A case squarely in point in that connection is *Bell v. Pleasant,* 145 Cal. 410, 78 Pac. 957 (1904), holding that plaintiff was required to prove only those facts necessary to its cause of action, and if it had alleged facts not necessary but which might have been alleged in defense and those facts were denied, this would not shift the burden of proof nor would it require plaintiff to introduce any evidence on the subject until defendants had produced evidence making a rebuttal necessary.

See also:

Lloyd v. Kleefisch, 48 Cal. App. 2d 408, 120 P. 2d 97 (1941).

For our purposes therefore, it is immaterial whether the condition is found to be precedent or subsequent for the burden of proving the non-existence of the condition must in any event fall upon Appellees.

C. Appellees Have Waived Their Right to Assert That the Obligation to Construct or Install Pipelines Was Subject to a Condition Precedent.

It is conceded by Appellees that they did not construct or install the pipelines and reservoirs prior to June 12, 1958, but that subsequently in or around 1960 they did commence the construction and installation work and did in fact complete it in 1961 so that pipelines were extended from the wells to each of the parcels comprising the Montgomery property, as required by the

agreement. It is conceded also that they have retained the wells and all of the property conveyed to them by Appellants; that they have used the water for irrigation purposes in connection with grazing cattle and the raising of alfalfa, for construction purposes and for domestic use at the residence; that they have furnished water to two mutual water companies; and that they have made no payments whatever to Appellants since September, 1957. Appellees even concede that they were dependent on such water as there was for development of a portion of the Montgomery land yet they contend that the water was nevertheless insufficient to service the Montgomery land for residential and industrial purposes. [Clk. Tr. pp. 71, 74, 153, 154, 156, 158, 253-254, 256-257]. It is submitted that Appellees have by such statements and conduct waived or abandoned any right they might otherwise have had, or excuse they might otherwise have asserted, based on nonexistence of a condition because they have proceeded to perform the very acts which they were obligated to perform under the agreement and which they contend they were excused from performing because of the insufficiency of water. In other words, Appellees by proceeding to render the performance which they claim was excused with the knowledge that the condition of sufficiency was not fulfilled thereby recreated their former duty and are precluded from now asserting the nonexistence of the condition to which it was subject.

The applicable California rule is set forth in *Woodard v. Glenwood Lumber Co.*, 171 Cal. 513, 163 Pac. 1017 (1915). This was an action by plaintiff to obtain a decree to the effect that defendant's rights under a

contract were terminated. Plaintiff was the owner of a 400 acre parcel of land and also an undivided ¾ interest in a neighboring 1400 acre parcel. Both parcels were valuable chiefly for timber. Plaintiff granted defendant the right to take, cut, haul and carry away timber upon prompt payment therefor at the rate of $2.25 per 1,000 feet of timber from the first tract and $1.68 per 1,000 feet from the second tract. Defendant agreed to erect a sawmill on the premises to have a certain capacity and to be constructed and ready to commence manufacturing and shipping operations *as soon as there was constructed and in operation a railroad from Santa Cruz crossing Gazos Creek.* Although the railroad was not completed defendant proceeded to and did construct and operate the sawmill. Plaintiff contended that although the railroad was not completed defendant had nevertheless constructed the mill and was therefore obligated to manufacture, ship and pay for lumber. Defendant claimed that the building of the railroad was a condition precedent to its obligation to manufacture and ship lumber and that it was not obligated to do this until such time. In holding for the plaintiff the court concluded the parties intended that certain timber should be removed from the land, but with respect to a beginning time for such removal it was not an agreement which defendant could indefinitely postpone, otherwise the purpose and benefit of the contract would be destroyed. This right to delay construction until completion of the railroad was said to be a privilege accorded to the defendant and accordingly could be waived. Defendant did waive it by constructing the sawmill and operating it and so brought about the event upon which its obligation to

manufacture rested. The court noted as significant factors that the land was chiefly valuable for timber, that the contract contemplated cutting it, that plaintiff was precluded from using the land while the contract was in force, and that defendant had an option to purchase the land.

See also:

LaMiller v. St. Claire Packing Co., 99 Cal. App. 2d 518, 222 P. 2d 75 (1950).

In order to determine whether a party has waived or surrendered a right which he might have had, it is not necessary to prove express language to such effect. On the contrary, this may be established by circumstances, a course of declarations, acts or conduct.

Alpern v. Mayfair Markets, 118 Cal. App. 2d 541, 253 P. 2d 71 (1953);

Waldteufel v. Sailor, 62 Cal. App. 2d 577, 144 P. 2d 894 (1944);

Bettlhein v. Hagstrom Food Store, 113 Cal. App. 2d 873, 240 P. 2d 301 (1952);

Wenzel and Henoch Construction Co. v. Metropolitan Water District, 115 F. 2d 25 (9th Cir. 1940).

In this connection Professor Corbin has made the following observation:

> "The primary contractual obligation of one whose duty is subject to a condition precedent is terminated just as soon as that condition can no longer be performed . . . Nevertheless, such a contractor has power to recreate his former duty—

sometimes by a mere voluntary expression of waiver—and nearly always by continuing to render his own performance or by receiving further performance from the other party with knowledge that the condition has not been performed."

3A Corbin on Contracts, p. 497.

The acts, conduct and circumstances in the case at bar which are conceded to have existed demonstrate conclusively that Appellees have waived and surrendered their right to now assert in defense of their failure to perform, excuse or nonexistence of a condition.

D. The Claim of Insufficient Water by Appellees Was Not Made in Good Faith.

In ruling that the question of sufficiency of water was not relevant or material to the issues in the case at bar [Rep. Tr. p. 365] the trial judge relied on the language of the agreement itself. He made the following observations: Appellees were given a period of nine months within which to test the wells and satisfy themselves as to sufficiency before they consummated the purchase, and they in fact did make an investigation and conduct tests; they were granted the right to return the wells at any time and be relieved of their obligation if not satisfied with the sufficiency, but they have retained the wells and have not reconveyed them; they were required to make certain payments to Appellants against the total purchase price remaining unpaid and they failed to make any further payments after September, 1957. The trial judge stated in this connection that Appellees could not acquire the wells, hold on to them, use them and refuse to pay for them and

he concluded quite properly that Appellees' acts and conduct were totally inconsistent with their claim of insufficiency [Rep. Tr. pp. 65, 66, 69, 365]. The trial judge must have reasoned that if there had existed a genuine concern as to sufficiency on the part of Appellees they would not have gone ahead to eventually construct the water system thereby incurring considerable expense [Clk. Tr. p. 253] but would have exercised their right to return the wells and avoid further liability, and that their claims of insufficiency therefore must not have been made in good faith.

III.

THE ORDER MADE BY THE TRIAL COURT DENYING APPELLEES' APPLICATION FOR A STAY OF PROCEEDINGS PENDING ARBITRATION WAS PROPER.

A. The Court of Appeals Has No Jurisdiction to Entertain an Appeal on This Point, the Right to Appeal Having Heretofore Been Waived by Appellees.

Appellees now contend that the District Court erred in not staying proceedings pending arbitration of the issue as to sufficiency of water and they further claim that their motion for a stay was properly framed under Rule 12(b)(1) of the Federal Rules of Civil Procedure and 9 U. S. C., Sections 1-4. Apparently, Appellees in asserting error are relying on their motion made on May 11, 1961 [Clk. Tr. pp. 201-202] and the trial court's ruling thereon although it should be noted that certain of their prior motions for a stay were based on the California arbitration statutes [Clk. Tr. pp. 54-58, 65-66, 77-78]. Significantly, no appeal was

taken by Appellees from the adverse rulings of the trial court on any of the occasions on which said motions were made although it is settled that where there is a special defense setting up an arbitration agreement as an equitable plea (as in the case at bar) and there is a denial of a motion for a stay, that decision is an appealable interlocutory order.

Gatliff Coal Co. v. Cox, 142 F. 2d 876 (6th Cir. 1944);

Shanferoke Coal & Supply Corp. v. Westchester Service Corp., 293 U. S. 449, 55 S. Ct. 313, 79 L. Ed. 583 (1935);

Hanover Motor Exp. Co. v. Teamsters Chauffers Helpers and Taxicab Drivers, 217 F. 2d 49 (6th Cir. 1954).

Accordingly, Appellees must now be deemed to have waived their right to an appeal on this point. Furthermore, the Court of Appeals at this time, has no jurisdiction to entertain an appeal purportedly taken from an interlocutory order entered over nine months prior to the notice of appeal.

9 U. S. C. §§3, 4;

28 U. S. C. §2107.

B. The Requirements of the Federal Arbitration Act, if Applicable, Have Not Been Met by Appellees.

Assuming for the purposes of the brief that the Court of Appeals does have jurisdiction to entertain the appeal from this order and that there has been no waiver by Appellees and assuming further that the Federal Arbitration Act is applicable, it can be readily

observed that Appellees have not brought themselves within the provisions of the Act. The Act requires (i) a contract evidencing a transaction involving commerce; (ii) an arbitrable issue; (iii) that the party seeking arbitration not be in default; and (iv) enforceability of the arbitration clause under applicable state law. None of these elements is present in the case at bar.

1. The Agreement Does Not Evidence a Transaction Involving Interstate Commerce.

It is clear that in order for the Federal Arbitration Act to be applicable the contract must involve a maritime transaction or interstate commerce.

> *Bernhardt v. Polygraph Co.*, 350 U. S. 269, 100 L. Ed. 199, 86 S. Ct. 273 (1956);
>
> *Kirschner v. West Company*, 185 F. Supp. 317 (E. D. Pa., 1960).

Obviously there is no maritime transaction involved here. It seems equally obvious from an examination of the agreement that the transaction does not have the faintest connection with commerce as that term is defined in Section 1 of the Act. The agreement contemplates the sale by Appellants of certain water wells and adjacent lands for a total purchase price of $1,000,000.00 to be paid for in installments over a period of time, plus 1/6 of the common stock of Simi. The wells and adjacent lands are all in California; the Appellants reside in California; the property to be developed and served by the wells is in California; Simi, although a Delaware corporation with an office in Dallas, Texas, carries on its operations exclusively in

California. It would indeed be difficult to imagine a situation so utterly removed from commerce as the transaction presented in the instant case.

The fact that Texas law may apply for purposes of construing the arbitration clause has nothing whatever to do with commerce. It arises from the fact that the original parties to the contract were residents of different states. The contract, as it happened, was executed in Texas creating a conflict of laws question but in a diversity case such as this conflicts questions frequently arise. Certainly, however, this does not affect or involve commerce even under the broadest interpretation.

2. There Is No Arbitrable Issue Before the Court.

It is essential under the federal act for the Court to satisfy itself that there is an issue susceptible of being arbitrated before it can order a stay. In this connection it is important the arbitration clause be read in its proper context. The provision is contained in Paragraph (f) of the agreement and by its terms relates solely and specifically to Paragraph 3 which reads as follows:

> "3. Subject to the physical ability of the well or wells now or hereafter located on the Water Lands to produce sufficient quantities of water so as adequately to service the lands covered by the Montgomery Contract with an adequate supply of water, contemplating that such lands will be developed for residential and industrial usages, I agree within two years from the date of the consummation of the purchase of the lands herein provided to be purchased by me from you, to install

> or construct or to cause to be installed or constructed a reservoir and pipe lines to transmit water produced from the Water Lands at least to the nearest boundaries of each of the three tracts of land covered by the Montgomery Contract." [Pltf. Ex. 1 in evid.].

The 2-year period referred to ended on June 12, 1958. The Appellees at that time had not constructed the reservoir and pipelines as required. They claimed they were excused from so doing because of insufficient water. In October, 1958, Appellants brought this action claiming default by Appellees and breach of contract by anticipatory repudiation. Thereafter, Appellees continued to hold the property and water wells conveyed to them by Appellants and subsequently, in 1960, commenced the construction of the pipelines and the reservoir completing it in 1961. As set forth in detail hereinabove (Point II), they have continued during this period to use the water for a variety of purposes.

Obviously then there was no bona fide controversy over sufficiency since not only have Appellees retained the lands and wells and continued to use the water for a variety of purposes but they performed the very act which they claimed was conditioned on sufficiency of water and thus did the very thing which would have been required of them had they been unsuccessful in an arbitration proceeding. There remains therefore no arbitrable issue to be decided.

3. Appellees Are in Default and Are Estopped From Asserting or Have Waived Any Right to Arbitration.

(a) Section 3 of Title 9 provides that a stay may be had provided "the applicant for the stay is not in default in proceeding with such arbitration." That Appellees are in default is amply demonstrated by their acts and conduct since the filing of this lawsuit.

The first occasion on which Appellees applied for a stay pending arbitration was June 30, 1959, nearly nine months after this action was filed [Clk. Tr. pp. 54-55]. This motion and all subsequent motions were denied by the trial court. In October, 1959 and thereafter Appellees proceeded with those matters which were consistent with preparation for trial such as filing a third party complaint, answers and counterclaims seeking declaratory and equitable relief; taking depositions; participating in pre-trial conferences; filing a memorandum of contentions of law and fact [*e.g.,* Clk. Tr. pp. 70, 150, 152, 164, 182, 190]. At no time did Appellees apply for specific performance of the arbitration provisions as they were entitled under 9 U. S. C. Section 4, nor did they appeal from the orders of the trial court denying their motions.

Under similar circumstances courts have held that the party is in default and has waived his right to arbitration or estopped himself from claiming such right. The theory is that a party cannot pursue two inconsistent courses of action—he must prosecute his claimed right to arbitrate—or he must go forward to trial, he cannot do both. That is precisely what Appellees have attempted here. For example, it has been held that a party to a contract containing an arbitration

clause was in default because it appeared, filed an answer to the complaint, set up a counter-claim for damages, requested a continuance on the ground that a material witness was absent and, in this instance, only moved for arbitration on the day set for trial.

Radiator Specialty Co. v. Cannon Mills, 97 F. 2d 318 (4th Cir. 1938).

See also:

American Locomotive Co. v. Gyro Process Co., 185 F. 2d 316 (6th Cir. 1950);

American Locomotive v. Chemical Research Corp., 171 F. 2d 115 (6th Cir. 1949).

(b) Also relevant in determining whether Appellees are in default and thus not entitled to relief under Section 3 are the actions and conduct of Appellees totally at odds with their insistence on arbitration. These have been set forth under Point I and Subsection (a) hereinabove and, accordingly have not been repeated here.

4. A Federal Court Cannot Compel Arbitration Where It Could Not Be Compelled in State Court.

(a) The decision in *Bernhardt v. Polygraph Co., supra,* makes it abundantly clear that the right of arbitration does not owe its existence to federal law. The Federal Court only enforces the state created right by rules of procedure, required by the federal act, not necessarily the same as state procedure. So in a diversity case, such as we have here, the federal court enforcing a state created right is only another court of the state. As pointed out in the *Bernhardt* case, arbitration carries no right to a jury trial: arbitrators do

not have judicial instruction on the law; arbitrators need not give reasons for the result; the record is not complete; judicial review of an award is restricted. Accordingly, the courts have concluded that the question of arbitration is a substantive one, likely to effect the outcome of any case. Therefore, in diversity cases federal courts look to the law of the forum to determine whether proceedings should be stayed pending arbitration, including, if relevant, the forum's law as to the conflicts of laws.

Bernhardt v. Polygraph Co., supra;
Jackson v. Atlantic City Electric Co., 144 F. Supp. 551 (D.N.J. 1956).

Questions involving conflict of laws are present here by reason of the fact that the contract although to be performed for the most part in California was nevertheless made in Texas between a resident of Texas and a resident of California and it was at least partially executed and performed in Texas. [*e.g.* Clk. Tr. pp. 233-237, 148-149, 438; Paragraphs 5A, 5B of Pltf. Ex. 1 in evid.]. For our purposes it can be assumed that the performance of certain acts by Simi, such as the issuance of stock to Appellants, required formal action by the corporation at its principal place of business in Dallas, Texas. Under these circumstances, questions relating to the validity of the contract and the provisions thereof such as an arbitration clause are to be determined by applying the law of Texas and a California court will look to the law of Texas to determine the

validity or enforceability of this clause, as the law of the place where it was made.

Mercantile Acceptance Co. v. Frank, 203 Cal. 483, 265 Pac. 190 (1928);

Cohen v. Metropolitan Life Ins. Co., 32 Cal. App. 2d 337, 89 P. 2d 732 (1939);

Restatement, Conflict of Laws §332.

Under Texas law, agreements to submit future disputes to arbitration are unenforceable, and can be revoked by the parties at any time before the award is made. An agreement in an executory contract to refer matters of dispute that may arise under the contract will not oust courts of jurisdiction and, when invoked for that purpose, will be held void.

Tejas Development Co. v. McGough Bros., 165 F. 2d 276 (5 Cir. 1947);

Florida Athletic Club v. Hope Lumber Co., 18 Tex. Civ. App. 161, 44 S. W. 10 (1898).

Since the question of the enforceability of the arbitration clause in this contract is one going to the validity of the contract Texas law would apply, and a Texas court would hold, under the rule as enunciated in the *Tejas* case, that the clause could not be asserted so as to deprive a court of jurisdiction.

Under the *Bernhardt* case, *supra,* the trial court was required to do likewise and it so ruled.

(b) Assuming, for purposes of argument, that California law must be applied, a stay would still not have

been proper. The controlling state statutes, under California law, are Sections 1280 and 1284 of the California Code of Civil Procedure. While these Code provisions set up an enforceable right to arbitration non-existent at common law (or under the law of Texas), they clearly do not provide an absolute right to arbitration merely because there is an arbitration clause in a contract. Rather, as the California Supreme Court in *Local 659, I.A.T.S.E. v. Color Corp. America,* 47 Cal. 2d 189, 302 P. 2d 294 (1956) has pointed out:

> ". . . a provision in a written contract to settle by arbitration a controversy arising out of the contract or the refusal to perform the whole or any part thereof 'shall be valid, enforceable and irrevocable, *save upon such ground as exist at law or in equity for the revocation* of any contract.' (emphasis added). It is thus indicated that there may be instances in which the right to enforce an arbitration provision is lost." (47 Cal. 2d at 194).

In this connection the decision of the Supreme Court of California in *Hanes v. Coffee,* 212 Cal. 777, 300 Pac. 963 (1931) is squarely in point. In that case plaintiff sought to quiet title to real property. Defendant claimed an interest in the property under a twenty year oil and gas lease but plaintiff contended that defendant's interest had terminated by reason of defendant's failure to comply with the terms of the lease and particularly, with the requirement that work be commenced within two years from the date thereof. De-

fendant asserted, among other defenses, a claim that the action was prematurely brought in that plaintiff failed to comply with an arbitration provision similar to the one involved herein. Answering this contention, the Supreme Court of California stated:

> "Conceding that this provision would be enforceable under our statutes, we do not think that it is applicable to the present controversy, in which the lessor contends that by reason of failure of the lessee to commence operations within the specified period, the lease never became operative, or if it did, is now terminated. The provision clearly does not contemplate that this question shall be submitted to arbitration, since if the allegations of plaintiffs' complaint are sustained, the result is that the lease, including the arbitration provision, is wholly inoperative, and the lessee can claim no rights thereunder." (212 Cal. at 779-780).

Similarly, in the instant case, the Appellees by repudiation of and failure to perform their express and implied obligations under the contracts, cannot now claim that while they have had no obligation to carry out the covenants imposed upon them, Appellants still were bound by the arbitration provision of the contracts

See also:

Abraham Lehr, Inc. v. Cortez, 57 Cal. App. 2d 973, 135 P. 2d 683 (1943);

Friedlander v. Stanley Productions, 24 Cal. App. 2d 677, 76 P. 2d 145 (1938); and

Feldman. Arbitration Law in California. 30 S.C.L.R. 375, 436 (1957).

(c) In *Robert Lawrence Co. v. Devonshire Fabrics,* 271 F. 2d 402 (2nd Cir. 1949) cited by Appellees, the Court, it is true adopted a restrictive view of the *Bernhardt* case and concluded that the Federal Arbitration Act established an entire new body of substantive law preempting the law of the respective states which prior thereto would have been applied.

The more reasonable interpretation of the decision reached in the *Bernhardt* case is that although prior to the adoption of the Federal Arbitration Act agreements to arbitrate involving commerce had been held invalid or unenforceable for policy reasons as ousting Courts of jurisdiction, now such agreements, pursuant to the provisions of the Act, become valid and enforceable *unless by other federal or state law such agreements are for other reasons held invalid, revocable or unenforceable.* Although the language in Section 2 might plausibly be read to support a broader view, it has been held that the legislative history reveals the intent of Congress to have been otherwise and that ambiguous statutory language ought not to be so read as to give it a reach beyond the Congressional intent as disclosed by the legislative history, among other things.

American Airlines, Inc. v. Louisville-Jefferson C. A. B., 269 F. 2d 811 (6th Cir. 1959)

Jackson v. Atlantic City Electric Co., supra.

C. Arbitration Would Have Been a Futile and Useless Act.

There is a further and equally compelling reason why arbitration should not have been permitted. The agreement between Appellants and Appellees provides in Paragraph (h) thereof as follows:

> "It shall be understood that, under Paragraph 8, I can at any time, at my option, reconvey the water lands to you and be relieved thenceforth of all obligations, if, in my opinion, the wells on the water lands are no longer capable of producing water in quantities sufficient to be commercially profitable to me, or if I deem that their operation is not economically feasible from my standpoint." [Pltf. Ex. 1 in evid.].

It is evident that this provision is totally inconsistent and at odds with the arbitration provision contained in Paragraph (f) and renders it meaningless for all practical purposes. It can be seen that even if the parties had resorted to arbitration, and even if Appellants had prevailed, Appellees in the exercise of their sole discretion as to sufficiency of water could have elected to relieve themselves of all obligations under the agreement by returning the wells and water lands to Appellants. Accordingly, an order requiring the parties to arbitrate could only have resulted in a futile and useless proceeding productive of nothing which would have assisted in eliminating the delay, harassment and expense of litigation which is the primary function of arbitration.

IV.

THE TRIAL COURT ERRED IN PRECLUDING APPELLANTS FROM FURTHER PROOF.

Appellees contend (Appellees' Br. Point IV, pp. 55-57) that there was no error precluding Appellants from further proof, because, they claim, the court was correct in holding, as a matter of law, that the contract could not be repudiated, and, also, because Mr. Riess' own testimony showed no repudiation in fact. The parties having stipulated to the dismissal of the jury, the power to make the factual determination is claimed to have been in the Court.

The first portion of this argument has been considered at length hereinabove (Point I), the circumstances under which Appellants are claimed to have stipulated to the dismissal of the jury is treated below (Point V). We consider here whether Mr. Riess' own testimony showed no repudiation in fact, and what effect, if any should be given to such testimony.

As the record shows, Mr. Riess was on the stand for three and one-half days; he was the first of a series of contemplated witnesses for Appellants. His testimony and the documents introduced during its course are summarized in Appellants' Opening Brief (pp. 7-8) and need not be repeated. In sum, Mr. Riess testified (as the trial court recognized) that Appellees, in a courteous and gentlemanly manner, and characterizing their position as a request for cooperation rather than as an ultimatum, unequivocally and categorically refused to construct the pipelines and reservoirs unless Appellants would first agree to accept late, partial performance as performance in full of their pipeline and reservoir con-

struction obligations. This construction being essential to the production of water for useful purposes, and such production being required before Appellants could be paid, this refusal was, obviously, critical. The fact that the refusal was conditional does not alter its significance as a breach, for Appellees had no right to extract such conditions. It is a settled rule of law that the annexing of an unwarranted condition to an offer of performance is in effect a refusal to perform.

Cal. Civ. Code, §1486;

Steelduct Co. v. Henger-Seltzer Co., 26 Cal. 2d 634, 160 P. 2d 804 (1945);

Loop Bldg. Co. v. De Coo, 97 Cal. App. 354, 275 Pac. 881 (1929).

Also the fact that Appellants may have urged Appellees to perform the agreement does not preclude them from treating Appellees' refusal to perform as a renunciation and as a breach, nor does it indicate that Appellants agreed to the condition which Appellees sought to impose.

Loop Bldg. Co. v. De Coo, supra.

Furthermore, the matters set forth in Appellants' offer of proof [Clk. Tr. p. 275], far from being cumulative, demonstrate dramatically the calculated and devious character of Appellees' breach.

Appellees apparently feel that a categorical repudiation is required; obviously, such a thing rarely occurs. More frequently, the rubric must be constructed out of numerous facts, events, conversations and documents, and the pattern becomes clear only when all witnesses have testified and all of the documentary evidence is in.

To claim, as Appellees do, that the matter *must* be concluded against Appellants after only one witness has testified (and particularly in view of the testimony), is to engage in fantasy.

Appellants do not concede that the court could under the circumstances here involved make any determination of fact in this case. As we will demonstrate hereinbelow, Appellees find the court empowered to do so only by an amazing process of mental gymnastics (Point VI, *infra*).

V.

THE AGREEMENT OF THE PARTIES THAT THE $28,000.00 PAID PRIOR TO JUNE 12, 1956, WAS TO BE A CREDIT ON THE PURCHASE PRICE DOES NOT REQUIRE THAT THIS SUM ALSO BE A CREDIT AGAINST THE FIRST MONIES TO BECOME DUE UNDER THE CONTRACT.

Appellees contend (Appellees' Br. point V, pp. 57-58) that the sum of $28,000.00 was properly credited against the first monies to become due to Appellants from Appellees, after the payment of the judgment. Both sides concede, of course, that the sum of $78,000.00 (the $28,000.00 paid prior to June 12, 1956, and the $50,000.00 "down payment") were to be a credit on the purchase price. Appellants contend that this sum should be credited against the last monies due them, and Appellees contend that *part* of this sum, specifically $28,000.00, should be credited against the first monies due. The trial court, held that the sum of $28,000.00 should be credited against the first monies due following payment of the judgment. While this was manifestly done in an effort to do justice among

the parties in an abstract sense, there is no basis for this in the agreement, nor by application of any principle of law.

That the parties intended that the sum of $28,000.00 *not* be credited against the first monies due is manifest from the following:

(1) The sum was not treated separately by the parties, but rather was dealt with by them along with the $50,000.00 down payment, which concededly was not to be a credit against the first monies to become due. Indeed the very sentence of the agreement of June 12, 1956, upon which Appellees rely deals, not with the sum of $28,000.00, but rather with the sum of $78,000.00 which ". . . is, and shall be, of course, a credit on the purchase price of said water lands and other properties."

(2) The phrase "a credit on the purchase price" obviously refers not to "first moneys" but to the purchase price referred to in the agreement, which, despite Appellees' protestations, was and is one million dollars. The agreement says so in so many words. If the parties had intended a portion of the sum they were dealing with to be a credit against first monies they could easily have said so but in adopting the language they did they rendered inescapable the conclusion that the credit was to be applied in reduction of the entire purchase price and for no other purpose.

(3) Notwithstanding the last paragraph of Point V of Appellees' Brief (p. 58), Appellees' conduct was not consistent throughout with the construction of the agreement now adopted by them. Rather, commencing immediately upon the consummation of the agreement,

Appellees paid to Appellants the sum of $2,000.00 per month. Appellees continued to do so for fifteen months until $30,000.00 had been paid. If we were to adopt Appellees' present construction of the agreement, either no payments should have been made during the first fourteen months or, alternatively, the payments should have ceased after ten had been made. Indeed, it was only after the dispute arose among the parties that the contention was advanced that an offset of some sort was in order. It is a familiar rule of construction that the intention of the parties is best ascertained by their construction of the agreement prior to the time any dispute has arisen.

Brown v. Cowden Livestock Co., 187 F. 2d 1015, 1019 (9th Cir. 1951);

Pacific Portland Cement Co. v. Food Machinery & Chemical Corp., 178 F. 2d 541, 554 (9th Cir. 1950);

Bohman v. Berg, 54 Cal. 2d 787, 795, 8 Cal. Rptr. 441, 356 P. 2d 185 (1960);

Whalen v. Ruiz, 40 Cal. 2d 294, 253 P. 2d 457 (1953).

Appellees suggest that if Appellants' contention were correct then Appellants would have use of $28,000.00 of Appellees' funds for an indeterminate period without any compensation to Appellees for their use. This argument ignores the fact that no matter what the outcome of this litigation, Appellees have had the use of Appellants' property, valued by the parties at over one million dollars, for more than six and one-half years and that no compensation therefor has been paid since the latter part of 1957.

VI.

APPELLANTS HAVE BEEN DEPRIVED OF THEIR RIGHT TO TRIAL BY JURY.

Appellees suggest that the dismissal of the jury did not infringe upon Appellants' constitutional rights for two reasons, *first*, because the parties stipulated out of the case the only remaining factual issue, and, *second*, because the jury was dismissed upon the agreement and stipulation of the parties (Appellees' Br. point VI, pp. 58-59). The first point is treated above (Point IV, *supra*) but the second requires further comment.

In the first place, the sequence of the trial must clearly be borne in mind. After the trial judge had ruled on the anticipatory breach point as a matter of law, he further ruled that the only remaining issue was that of damages for the simple breach of contract. Taking the trial judge's ruling on the anticipatory breach point as correct, this latter ruling followed without dispute. The parties then stipulated for the purposes of the case as to the amount of damages for the simple breach and there were indeed no further issues to be tried. The transcript then sets forth the discussions of the parties with respect to what should be done procedurally, Appellants taking the position that the jury should be instructed to bring in a verdict in conformity with the court's legal rulings and the stipulation of the parties, and Appellees taking the position that the jury should be dismissed [Rep. Tr. pp. 493-507]. The court refused to instruct the jury and stated that the jury

should be dismissed, that findings should be made as to the undisputed and stipulated facts and the resultant conclusions of law. In view of the court's legal rulings with regard to the applicability of the doctrine of anticipatory breach to the contract before it and the court's refusal to instruct the jury, there was indeed no alternative remaining but to dismiss the jury and this was done.

It was after this, in fact several weeks after this, that the court adopted the findings of fact proposed by the Appellees, which, as we have indicated, purported to determine disputed issues of fact against the Appellants.

Appellees suggest that since the jury had been dismissed by stipulation it was within the power of the court to make such findings of fact. This contention ignores the obvious, that the jury had been discharged only upon the express assumption of the court and of the parties that no material issues of fact existed. The court could not reverse its position and find upon these issues adversely to Appellants without infringing upon Appellants' constitutional right to a trial by jury.

CONCLUSION.

It is apparent from the record before the Court that the Appellants have been grievously damaged by the wanton disregard, on the part of the Appellees, of their contractual obligations. Appellants are entitled to their day in court and to the due consideration of all of their

evidence by the jury. This having been denied, the judgment of the Court below should be reversed, and the cause remanded.

Respectfully submitted,

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CERTIFICATE.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT A. HOLTZMAN

No. 18199

United States
COURT OF APPEALS
for the Ninth Circuit

CLARA RUDICK,

Appellant,

v.

PIONEER MEMORIAL HOSPITAL,
DENISON M. THOMAS, M.D., and
CHARLES E. DONLEY, M.D.,

Appellees.

BRIEF OF APPELLEE DENISON M. THOMAS, M.D.

On Appeal from the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, Judge.

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SUBJECT INDEX

TABLE OF CASES

OTHER AUTHORITIES

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BRIEF OF APPELLEE DENISON M. THOMAS, M.D.

On Appeal from the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, Judge.

STATEMENT OF THE CASE

In this malpractice action, plaintiff sought to recover $125,000 general damages and over $8,000 in special damages from Prineville Memorial Hospital, Dr. Denison M. Thomas, a Prineville, Oregon general physician, and Dr. Charles E. Donley, a Bend, Oregon physician specializing in the field of radiology and roentgenology (Pretrial order, pp. 3-5).

Plaintiff claimed that as the result of an automobile accident near Mitchell, Oregon, on May 25, 1957, she suffered "a fracture of the vertebra of her neck, the fifth cervical vertebra and a compression fracture of the sixth cervical vertebra and a subluxation or dislocation of the vertebra of her neck." It was claimed that defendants "so negligently and carelessly examined and treated plaintiff that as a proximate result of said negligence said previous injury to the plaintiff's neck was aggravated" and plaintiff suffered further painful and permanent injuries as well as mental anguish (Pretrial order, p. 3).

Earlier proceedings herein are summarized in this Court's opinion (296 F.2d 316) passing upon plaintiff's appeal from a judgment holding that her general release to the driver of the automobile for a payment to her of $4250 barred the prosecution of this action. For reasons therein stated, this Court reversed the case "with instructions that judgment upon the segregated issue be set aside and for further consideration and determination of that issue upon the present record in the light of this opinion" (296 F.2d at p. 320).

Following receipt of this Court's mandate, the district court set this case for trial before a jury on the issues presented in the pretrial order, excluding the release issue.

At the commencement of the trial, the court approved the dismissal by stipulation of the action as against defendant hospital (Tr. 2). At the close of plaintiff's medical testimony, the court granted defendant Donley's mo-

tion for a directed verdict and plaintiff's trial counsel made no objection to the court's ruling (Tr. 215-216). The case was submitted to the jury against defendant Thomas alone and the jury returned a general verdict in his favor. No motion for a new trial was filed.

PROCEDURAL RULES INVOLVED

Rule 46 of the Federal Rules of Civil Procedure provides:

> "Rule 46. Exceptions Unnecessary
>
> "Formal exceptions to rulings or orders of the court are unnecessary; but for all purposes for which an exception has heretofore been necessary it is sufficient that a party, at the time the ruling or order of the court is made or sought, makes known to the court the action which he desires the court to take or his objection to the action of the court and his grounds therefor; and, if a party has no opportunity to object to a ruling or order at the time it is made, the absence of an objection does not thereafter prejudice him."

Rule 51 of the Federal Rules of Civil Procedure provides:

> "Rule 51. Instructions to Jury: Objection
>
> "At the close of the evidence or at such earlier time during the trial as the court reasonably directs, any party may file written requests that the court instruct the jury on the law as set forth in the requests. The court shall inform counsel of its proposed action upon the requests prior to their arguments to the jury, but the court shall instruct the jury after the arguments are completed. No party may assign as error the giving or the failure to give an instruction unless he objects thereto before the jury retires to consider its verdict, stating distinctly

the matter to which he objects and the grounds of his objection. Opportunity shall be given to make the objection out of the hearing of the jury."

SUMMARY OF ARGUMENT

1. The fact that plaintiff's brief completely disregards this Court's rules is sufficient reason for dismissal of this appeal.
2. Alleged errors in trial court proceedings may not be raised for the first time in this Court.
3. Even if the claimed errors had been properly raised below, they are completely lacking in merit.

ARGUMENT

I

Plaintiff's Violations of Rule 18 Are Sufficient Grounds for Dismissal of this Appeal.

Preliminarily, we are constrained to point out that plaintiff's brief completely disregards the requirements of Rule 18 of this Court's rules, which this Court has repeatedly held must be observed (*Pacific Queen Fisheries* v. *Symes,* 307 F.2d 700, 705 (CA 9)). For this reason alone, dismissal of this appeal is warranted (*Thys Co.* v. *Anglo California National Bank,* 219 F.2d 131, 133 (CA 9), cert. den. 349 U.S. 946, 75 S.Ct. 875, 99 L.Ed. 1272, rehearing denied 350 U.S. 855, 76 S.Ct. 40, 100 L.Ed 760).

Obviously, the purpose of the Court's requirement in

Rule 18, sub 2(g), that an attorney certify as to his examination of and compliance with Rules 18 and 19, was to compel adherence to the Court's rules. However, no certificate is attached to plaintiff's brief.

Many other obvious violations of Rule 18 can be found in this brief:

1. There is no table of exhibits (Rule 18, sub 2(f)).
2. There is no summary of the argument (Rule 18, sub 2(e)).
3. Most of the alleged specifications of error do not conform to the requirements of Rule 18, sub 2(d), since
   (a) the alleged errors are not set out "separately and particularly";
   (b) with respect to the alleged errors as to admission of evidence, the specifications do not quote "the full substance of the evidence admitted," and do not "quote the grounds urged at the trial for the objection";
   (c) with respect to alleged errors as to the court's charge, the specifications do not "set out the part referred to totidem verbis" and "the grounds of the objections urged at the trial" are not shown.

As will appear presently, the failure to set out the grounds of objections made in the district court is not merely a technical defect, for the record shows that no objections were ever asserted during the trial.

II

No Objections Having Been Made at the Trial, the Alleged Errors May not Be Considered by this Court.

When separated, the alleged errors with respect to the trial proceedings (Specifications of Error Nos. 2-13, App. br., pp. 24-26) fall into six main categories:

1. that the trial court erred in its rulings on direct and cross-examination (Nos. 2-3);
2. that the trial court erred in its own examination of certain witnesses (Nos. 4-5);
3. that the trial court erred in its comments during the trial (Nos. 6-7);
4. that the trial court erred in receiving inadmissible testimony (No. 7);
5. that the trial court erred in its instructions to the jury (Nos. 8-10, 13);
6. that the trial court should have directed a verdict for plaintiff, or that the trial court should have set aside the verdict which the jury returned against the plaintiff (Nos. 11-12).

A perusal of the transcript of testimony demonstrates that this Court cannot review any of the alleged errors because plaintiff's trial counsel made no objection whatsoever at the trial to any of the court's actions or rulings; nor did he make a motion for a directed verdict in plaintiff's favor, or for judgment n.o.v. With respect to the jury instructions, the only objection made was unintelligible and is not relied upon by plaintiff in this Court (Tr. 298).

Two fundamental rules of federal court trial procedure are Rule 46, FRCP, and Rule 51, FRCP, quoted above. As applied to this case, Rule 46 required that plaintiff's trial counsel make known to the district court the action he desired the court to take, or his objection to the action of the court and his grounds therefor. Rule 51 required that before the jury retired, plaintiff's trial counsel object to instructions given and state distinctly the matter to which he objected and the grounds of his objection (see discussion 2B *Barron and Holtzoff, Federal Practice and Procedure,* § 1021, pp. 309-319, and §§ 1103-1104, pp. 450-465, and cases cited therein; see also discussion Vol. 13, *Cyclopedia of Federal Procedure* (3rd Ed.), Chapter 59, pp. 331-381).

In *Johnston* v. *Reilly,* 160 F.2d 249, 250 (Ct. App. D.C.), the court referred to Rule 46 as "a codification of the rule already existing" and further stated:

> "This is not a mere technicality but is of substance in the administration of the business of the courts. Enormous confusion and interminable delay would result if counsel were permitted to appeal upon points not presented to the court below. Almost every case would in effect be tried twice under any such practice. While the rule may work hardship in individual cases, it is necessary that its integrity be preserved."

Plaintiff's counsel relies upon the decision of the Court of Appeals for the Third Circuit in *Callwood* v. *Callwood,* 233 F.2d 784, 788, for the proposition that this Court can consider objections made for the first time on appeal where "the error in the charge was fundamental and highly prejudicial, and our failure to con-

sider the error would result in a gross miscarriage of justice." This is merely a statement of the "plain error" rule which some federal appellate courts apply to civil appeals.

While we vigorously deny that the trial court committed error, plaintiff could fare no better even if this Court discovered "fundamental and highly prejudicial" error urged for the first time on appeal.

This Court has repeatedly held "that the 'plain error' rule may not be utilized in civil appeals to obtain a review of instructions given or refused where the ground asserted was not voiced in the trial court" (*Hargrave* v. *Wellman,* 276 F.2d 948, 950 (CA 9), followed in *Bertrand* v. *Southern Pacific Co.,* 282 F.2d 569, 572 (CA 9), cert. den. 365 U.S. 816, 81 S.Ct. 697, 5 L.Ed. 2d 694).

In commenting upon these cases, Vol. 2B, *Barron and Holtzoff, Federal Practice and Procedure,* § 1106, pp. 474-475, states:

> "* * * At least one circuit reads the rule literally, and holds that it does not have power to reverse even for plain error. Such a reading, in addition to being consistent with what the rule says, undoubtedly spares that circuit from the burden of having to review afterthought claims of errors in the instructions which counsel attempt to bring forward under the banner of plain error. * * *"

Illustrations of the application of Rules 46 and 51 by recent decisions of this Court are found in *Brown* v. *Chapman,* 304 F.2d 149, 154 (CA 9) [instructions]; *Dale Benz, Contractors* v. *American Casualty Company,* 305 F.2d 641, 643 (CA 9) [necessity of obtaining ruling

upon objections to evidence]; *Bohauer* v. *Friedman,* 306 F.2d 933, 937 (CA 9) [genuineness of document first challenged on appeal]; *Southern Pacific Company* v. *Villarruel,* 307 F.2d 414, 415 (CA 9) [new ground of objection to instruction]; and cf. *Frank* v. *International Canadian Corporation,* 308 F.2d 520, 529 (CA 9) [attempt on appeal to depart from pretrial order].

Thus, since the record is barren of any objections made at trial with respect to the multitude of "errors" of which plaintiff now complains, the above-cited authorities clearly show that there is nothing for the Court to review on the appeal from the judgment in favor of Dr. Thomas.

III

In Any Event, the Alleged Errors Are Without Merit

Notwithstanding the absence of grounds for review, we cannot close this brief without briefly pointing out the frivolous nature of the alleged errors which plaintiff's counsel seeks to raise for the first time in this Court. In this connection, we will only comment on the alleged errors mentioned on pages 34-45 of plaintiff's brief which are claimed to have been "more serious and prejudicial" than certain other alleged errors mentioned in the "Specifications of Error," but not argued.

1. First, it is claimed that the trial court committed prejudicial error with respect to the examination of Dr. Donley. The transcript clearly shows that the court's questions were clear and to the point (Tr. 73-75). Furthermore, the court invited plaintiff's counsel to ask further questions (Tr. 75).

2. It is also claimed that the court was guilty of prejudicial error in its examination of plaintiff's witness, Dr. Shipps. Again, the transcript clearly shows that the court did not act arbitrarily in conducting a clear and elucidating examination of the witness (Tr. 126-129). With respect to the trial court's right and duty to facilitate the orderly progress of the trial by participating in the examination of witnesses, we refer the Court to Judge Bone's opinion in *Ochoa* v. *United States,* 167 F.2d 341, 344 (CA 9).

3. Complaint is made that the court erred in admonishing the plaintiff when she commenced to characterize her surgery as "a horrible thing" (Tr. 143). To tell the witness to answer the question, and not make side remarks, certainly was within the trial court's discretion.

4. Next, the court's admonition to Dr. Stern not to be coy, but to give his full opinion and not hold back, was perfectly proper in view of his previous testimony, for he had stated that his previous answer was not his full answer (Tr. 206-207).

5. The claim that the court required plaintiff's counsel to examine Dr. Donley as his own witness misses the point. The record (Tr. 68) shows that when plaintiff's counsel commenced to interrogate Dr. Donley on matters that related to his case against Dr. Thomas, the court asked counsel whether he was calling Dr. Donley as his own witness. Counsel agreed that he was "for this limited function" (Tr. 68).

6. Error is predicated on the trial court's comments on plaintiff's injuries and condition (Tr. 225). Not only does any federal judge have broad powers to comment on the evidence but the court specifically instructed the jury: "Remember at all times that you, as jurors, are at liberty to disregard all comments of the court in arriving at your own findings as to the facts" (Tr. 281), and "* * * you are to decide the questions of fact involved in this case solely upon the basis of the evidence that has been introduced in this case" (Tr. 281) [see opinion of Judge Healy in *Bradley Min. Co.* v. *Boice,* 194 F.2d 80, 83 (CA 9)].

7. The contention is made that error was committed in allowing plaintiff to testify on cross-examination that she had received $4250 in settlement from the driver of the automobile. Paragraph V of defendant's contentions in the pretrial order made this evidence relevant (Pretrial order, p. 7). Under Oregon law, such evidence was admissible since Locke and defendants stood in the position of joint tort-feasors. Even if the release was to be construed as a covenant not to sue, the amount received in that settlement would have been properly deducted by the court from any verdict which plaintiff had obtained against Dr. Thomas (see *Southern Pacific Co.* v. *Raish,* 205 F.2d 389, 393 (CA 9)). The jury was not instructed on this procedure (Tr. 276-277). As for the court's comment, plaintiff's counsel fails to note that all the trial proceedings at pages 270-

278 of the transcript of testimony were outside the presence of the jury.

8. With respect to alleged errors in the court's instructions to the jury, it is probably sufficient to point out that the instruction to the effect that a mere error in judgment is not negligence (Tr. 285-286) is a correct statement of Oregon law (*Malila* v. *Meacham,* 187 Or 330, 354-355, 211 P.2d 747, followed in *Eckleberry* v. *Kaiser Foundation,* 226 Or. 616, 626-627, 359 P.2d 1090). The remainder of the claimed errors in instructions (App. br., pp. 42-44) relate solely to the question of damages. However, since the jury returned a general verdict in favor of Dr. Thomas on the issue of liability, it never reached the question of damages, so any possible error in the instructions on that subject was harmless (*Blanton* v. *Great Atlantic & Pacific Tea Co.,* 61 F.2d 427, 429 (CA 5); *Bryne* v. *Greene,* 70 F.2d 137, 139 (CA 1); *Ackelson* v. *Brown,* 264 F.2d 543, 547 (CA 8)).

9. In conclusion, error is predicated on the assertion that the jury's verdict was contrary to law and contrary to the evidence, and that there was no substantial or preponderant evidence to support the jury's verdict. The short answer is that while plaintiff may have made out a sufficient case for submission to the jury as to the negligence of Dr. Thomas, the evidence did not require that the court direct a verdict in her favor, and plaintiff's counsel did not move for a directed verdict,

or for judgment n.o.v., or for a new trial. Thus, there is nothing for this Court to consider (*Trans World Airlines* v. *Shirley,* 295 F.2d 678 (CA 9)). Without discussing the sufficiency of the evidence of Dr. Thomas's alleged negligence, it is enough to note that the jury could have found in his favor on merely the testimony of the expert witness, Dr. Samuel R. Orr (Tr. 244-254).

CONCLUSION

This appeal appears to us "to closely approach the frivolous and vexatious" (*Cakmar* v. *Hoy,* 265 F.2d 59, 62 (CA 9)). Plaintiff's new appellate counsel obviously entered into his representation of plaintiff without being apprised of the trial court record. His willingness to proceed with the appeal against Dr. Thomas must be attributed to zeal for his client, rather than a dispassionate consideration of the merits of the appeal.

In fact, this appeal is without merit and should either be dismissed, or the judgment of the district court in favor of Dr. Thomas should be affirmed, with costs.

Respectfully submitted,

HUGH L. BIGGS,
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CLEVELAND C. CORY,
Attorneys for Appellee
Denison M. Thomas, M.D.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CLEVELAND C. CORY,
Of Attorneys for Appellee
Denison M. Thomas, M.D.

No. 18,200

IN THE

United States Court of Appeals

For the Ninth Circuit

MARVIN SHERWIN,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

APPELLANT'S PETITION FOR A REHEARING

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Subject Index

Table of Authorities Cited

Cases

Rules

Statutes

No. 18,200

IN THE

United States Court of Appeals

For the Ninth Circuit

MARVIN SHERWIN,	*Appellant,*
VS.	
UNITED STATES OF AMERICA,	*Appellee.*

APPELLANT'S PETITION FOR A REHEARING

To Circuit Judges, Honorable Walter L. Pope, Honorable Stanley N. Barnes and Honorable Gilbert H. Jertberg:

Now comes Marvin Sherwin through his attorneys, James E. Burns and Richard H. Foster, and petitions this Court for a rehearing in the case of *Sherwin v. United States,* No. 18,200, decided June 11, 1963, and suggests, for the reasons hereinafter stated, that the case be reheard en banc.

I. THE COURT HAS INCORRECTLY INTERPRETED APPELLANT'S DEFENSE.

Ordinarily, we would not urge the facts surrounding the defense of lack of wilfulness to the Court of

Appeals since this defense is one which the jury's verdict usually removes from this Court's review. Here, however, where one of the principal grounds of appeal is that the Court's instructions on wilfulness were improper, we think it important that the Court understand the nature of the defense presented to the jury and, as here, where an instruction was given which this Court has previously held to be plain and reversible error we feel it our duty to correct what we believe to be the Court's erroneous interpretation of the defense.

In Footnote 26 of the Opinion, the Court makes the assertion that there was no claim that appellant *thought* the Bechtel losses affected his tax liabilities for the years 1954, 1955 and 1956. This statement we believe to be erroneous. If the Court will examine the original claim for refund (Exhibit E) in connection with these losses, it will note that the claim is for an operating loss carry back. A capital loss cannot be an operating loss carry back. In the technical computation of the amount of operating loss, the accountant treated a portion of the Bechtel loss as a capital stock loss. One unfamiliar with the involved techniques of tax accounting, however, would assume that the entire loss claimed was the kind of loss which could be carried back and carried forward, thus in this case affecting, by way of carry forward, the years 1954, 1955 and 1956. In the event a capital loss was involved, appellant, as the Government conceded and in fact gave credit in its computations, could take One Thousand Dollars ($1,000) as against ordinary

income in the indictment years. Joyce, appellant's accountant, however, a former Internal Revenue agent, did not deduct this One Thousand Dollars ($1,000) even though if the loss had been capital in nature, it would have been a proper deductible item. As Joyce, appellant, and other witnesses testified, everyone realized that because of the complex nature of appellant's affairs, amended returns would necessarily have to be filed. As appellant stated in his statement to the Internal Revenue Service in connection with his refund claim (Exhibit B), the exact amount of the Bechtel losses were not known at that time. The total amount of appellant's losses, as this Court itself recognizes, will not be established until the final determination of the Santa Rosa litigation. It was natural, therefore, for appellant to assume that these losses could be established by a claim for refund filed in the same manner as the one which the Government granted. (Government Exhibit 12.)

Even from a technical point of view, the loss claimed on the 1952 claim for refund resulted in ordinary loss treatment for the Bechtel interests and an operating loss carry forward. Appellant was treated as a promoter of corporations. Otherwise, the payment by him of corporate obligations would not give rise to an ordinary loss. It is this fact which makes any losses therefrom deductible in full. (We might add that a closing agreement would not be necessary to bind the Department of Justice, the Grand Jury or the Courts. The cases referred to by the Court refer only to a determination by the Commissioner and do

not affect Section 6404 of Title 26, since the Commissioner is not a party to this action and never has been.)

In any event, the Government treated the Bechtel losses as an operating loss which could be carried forward. Appellant's accountant, in the 1954, 1955 and 1956 tax returns, did not treat them as capital losses. Appellant at all times has maintained that he believed his losses far overcame any income which he earned in the indictment years.

We reiterate that we are not attempting to reconstitute this Court of Appeals as a jury passing on the issue of appellant's wilfulness or lack of wilfulness. We, however, believe that considering our arguments on the trial Court's instructions on that subject, the Court should bear in mind that appellant claimed, and reasonably could have thought, that he overpaid his taxes in the indictment years.

II. THE COURT'S RULING ON THE MURDOCK INSTRUCTIONS IS IN CONFLICT WITH THE FACTS AND OTHER DECISIONS OF THIS COURT.

The Court, in its opinion, while not directly asserting that the so-called Murdock instructions given by the Court were in error, does not indicate that it disagrees with *Bloch v. United States,* 9th Circuit, 221 Fed. 2d 786; *Abdul v. United States,* 9th Circuit, 254 Fed. 2d 292; *United States v. Palermo,* 3rd Circuit, 295 Fed. 2d 872. The Court simply refuses to exam-

ine the question on the grounds that proper objection was not made to the instructions.

The Murdock instruction was given twice by the Court. One of these instructions apparently was originally submitted by the defense, that is, defense instruction 19. The other instruction, however, TR 1115-1116, contains a portion of the exact language used by the Government in the instruction to which objection was made. We quote the Court's statement of the instruction to which objection was made:

> ". . . If a man in good faith believes he has paid all the taxes he owes he cannot be guilty of criminal attempt to evade the tax. But if a man acts without reasonable grounds for belief that his conduct is lawful, it is for the jury to decide whether he willfully intended to evade the tax. . . ."

The instruction actually given was as follows:

> "If a taxpayer honestly believes that he has paid all the taxes he owes, he is not guilty of criminal evasion. But if he acts without reasonable grounds for belief that his conduct was lawful, it is for you to decide whether he was acting in good faith or whether he intended to evade the tax."

Rule 30 contains no other requirement than that a defendant object to an instruction. This, appellant's counsel did. Even assuming that appellant, by objecting to the quoted language did not withdraw or object to the same language which appears in defense instruction 19, it appears to us that appellant has

done all that he reasonably can be expected to do in the way of objecting to the instruction quoted above which was given by the Court.

We must emphasize this is not a case where the trial Court was misled by counsel. The objection was given prior to instructions. The Court was specifically advised of the precise cases which disproved the instruction. The Court advised counsel that it would read these cases. After the Court had read these instructions, it nevertheless, after opportunity for reflection, gave it anyway. The Court, in fact, gave it not once, but twice. Despite the fact that in *Bloch v. United States,* supra, this Court held that the instruction was plain error and despite the fact that in this case, as we previously indicated, the definition of "wilfulness" was crucial.

In *Herzog v. United States,* 235 Fed. 2d 664, no objection at all was made to the instruction there given. The matter was not even raised on appeal but only on a petition for rehearing. Furthermore, there the case turned on a factual dispute, as this Court emphasized. As the Court there stated, "There was no claim on his part of inadvertence, mistake or the like. The issue was squarely one of credibility. . . ." Here the facts were stipulated and the issue involved was a simple question of wilfulness or non-wilfulness in signing the return.

We submit to the Court that no greater burden rests on the defense than to object to an improper instruction once. That once an objection to the instruction is made, even if that instruction is repeated in

order to save his record on appeal the same objection need not be repeated again and again. We think that this principle is particularly applicable in a case where this Court has held the instruction to be plain error under Rule 52.

Our conclusion in this matter is reinforced by the trial Court's instruction on intent. This Court does not overrule *Bloch v. United States,* supra, and indicates that a specific instruction referring to tax cases with respect to the natural and probable consequences of omitting income was error. We believe that the general instruction given here can be no less erroneous because of the absence of specific language. It seems to us a novel theory and one that should be reconsidered by the whole Court that the position in which an instruction is found, the fact that it is general rather than specific and that some of the instructions given were proper ones rehabilitates an instruction. Here, the Court gave a bad instruction on wilfulness and what appears to be a bad instruction on intent. We cannot see how improper instructions on these subjects in a case of this character could have any other result than a grave miscarriage of justice and an unfair trial.

III. THE COURT'S RULING ON THE PLAZA BUILDING INSTRUCTION RAISES GRAVE PROBLEMS.

The Court, with respect to appellant's complaint of the rejection of instruction 36, states as follows:

> "Here again we think that the evidence is insufficient to show any such loss. The evidence

> shows that litigation between Tarman and Sherwin with respect to their several rights in the properties of the partnership were still pending in the state court at Santa Rosa but no judgment had been entered in that case. Sherwin testified that at the time of the trial that property remained in a 'status quo'. The upshot of this is that if Sherwin ultimately should lose that property or his interest therein, a loss might then occur, but if he should win he would be liable for additional unreported partnership income for the years here in question arising out of the profits of the 'Plaza Building'. We find no error in the rejection of this proposed instruction."

It is apparent that the Court recognizes that if the Santa Rosa litigation ends adversely to appellant, he may have a sizeable tax loss. We feel we should inform the Court that since the trial in this case, the Santa Rosa litigation has ended unfavorably to appellant. While this action is presently on appeal, in the event that the Santa Rosa Court's judgment is upheld, appellant will have lost the Plaza Building whose tax basis is Seventy-Five Thousand Dollars ($75,000), that is to say, approximately twice the amount which the Government claims appellant evaded. This loss, as the Court can determine from an examination of the opinion of the Santa Rosa Court introduced in evidence, occurred in the year 1954, one of the indictment years. It is based upon a contention by Mr. Tarman that appellant transferred this property to him in that year. Appellant's loss, under elementary tax law pursuant to Section 1231

of the Internal Revenue Code, would have occurred in that year and would have wiped out any income tax liability. In other words, if the Santa Rosa judgment remains as it is, this Court will have affirmed a judgment where a taxpayer has overpaid his taxes. It will have justified a jail sentence for a man innocent as a matter of law. Even the Government concedes, and this Court has previously indicated, that an individual cannot be convicted unless he has evaded income tax.

We did not ask the Court below to rule as a matter of law on the Plaza Building losses. But even though the decision of the Santa Rosa Court is not final, the facts on which this decision was based existed at the time of the filing of the tax returns and existed at the time of the trial. We submit that the jury should have been allowed to pass on these facts and determine whether or not appellant, under the Internal Revenue laws, owed additional income tax not reported by him.

IV. OTHER ERRORS.

We believe that the Court's treatment of the various claims of error surrounding the introduction by the Government of failure to report partnership income is inconsistent. The Court concedes that the introduction of evidence of unreported partnership income was probably error. It, however, seeks to justify the giving of an instruction on this admittedly improper evidence on the basis that there was evi-

dence of unreported partnership income. Furthermore, it then justifes the denial of Agent Neilands' report on that partnership on the basis that this evidence was not in the case because not listed among the items which formed the Government's bill of particulars. It is our position that if this evidence was admissible at all under any theory, then the defense had the right to examine Agent Neilands' report concerning it. We do not believe, considering the trial Court's express instruction on the subject, that the failure of the Court to allow the defense even an opportunity to examine this report can be considered a harmless matter. The accountant, Moran, did not ever claim that he had access to all of Neilands' work papers nor did he ever claim he had examined the report in question. We submit that elementary considerations of fair play require that where evidence is introduced against a defendant, the defendant should have an opportunity to investigate relative evidence bearing on the point even though that evidence is contained in a Government report.

We must also respectfully disagree with the Court's statement that the Government did not attempt to paint appellant a scoundrel by trying to show that he took legal fees while on the bench. An examination of the various transactions involved will demonstrate to the contrary. The Tarman, Jr. testimony referred to a transaction which occurred after appellant took the bench and the whole purpose of this testimony was designed by the prosecution to discredit and disparage appellant.

V. CONCLUSION.

This case presents a difficult and delicate problem to the Court. We recognize the natural feeling of horror of everyone created when a member of the judiciary is involved in criminal litigation. The natural inclination is to immediately assume that since the defendant, and appellant here, was a judge "he should have known better." However, the danger exists that this feeling can so permeate the case as to prejudice that which even a Superior Court Judge is entitled to—a fair trial. Where, as here, the mere fact of accusation supercharges the emotions, stringent care must be taken to insure that the proceedings are proper. In the instant case, in the last analysis, the crucial issue is whether appellant negligently prepared his tax return or wilfully attempted to evade taxes. Because of his position, the possibility of finding an unprejudiced lay jury is remote. The instructions, therefore, which set the standards under which he is tried must be clear and in accordance with the law. In the present case, appellant was convicted under a definition of "wilfulness" which the Court felt was improper in trying a notorious gangster. (*United States v. Palermo,* supra.) It should be emphasized that in the *Palermo* case the standards were those imposed by the Court in a Court trial, rather than instructions given a lay jury. Here, where the majority of the facts were stipulated and where a lay jury is judging one who in the very nature of things they cannot realize is a fallible human being, this instruction is of crucial importance. We simply ask

each judge of the Court of Appeals to consider whether or not if he were in like circumstances to appellant he would believe that the instructions on intent and wilfulness given here were proper.

Dated, San Francisco, California,
July 11, 1963.

James E. Burns,
Richard H. Foster,
Attorneys for Appellant and Petitioner.

CERTIFICATE OF COUNSEL

We hereby certify that in our judgment this petition for rehearing is well founded and is not interposed for delay.

Dated, San Francisco, California,
July 11, 1963.

James E. Burns,
Richard H. Foster,
Attorneys for Appellant and Petitioner.

AFFIDAVIT OF MAILING

State of California

City and County of San Francisco - SS

M. J. Connolly, being first duly sworn deposes and says:

That he is a citizen of the United States of America, over the age of twenty-one years and not a party to the action of "Sherwin vs. United States of America", in the United States Court of Appeals, for the Ninth Circuit, No. 18200;

That on July 11, 1963, he mailed by first class mail, postage prepaid, three copies of the appellant's petition for a rehearing, in the above entitled action, to Cecil F. Poole, United States Attorney, 422 Post Office Building, San Francisco, the attorney for appellee. The above is the last known address of said attorney.

M. J. Connolly

Subscribed and sworn to before me
this 11th day of July, 1963

Marie B. Sullivan

Notary Public in and for the
City and County of San Francisco
State of California

No. 18,200

IN THE

United States Court of Appeals

For the Ninth Circuit

MARVIN SHERWIN,
Appellant,

v.

UNITED STATES OF AMERICA,
Appellee.

BRIEF FOR APPELLEE

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INDEX

(Table of Authorities Cited on next page)

TABLE OF AUTHORITIES CITED

Cases

Statutes

Other Authorities

No. 18200

In The

United States Court of Appeals

For the Ninth Circuit

Marvin Sherwin,

Appellant,

v.

United States of America,

Appellee.

BRIEF FOR APPELLEE

JURISDICTION

Jurisdiction is invoked by appellant under Title 26, United States Code, Sections 7201 and 7206(1), and Title 28, United States Code, Sections 1291 and 1294(1).

STATEMENT OF THE CASE

An indictment was returned in the Northern District of California on July 14, 1961, charging appellant with three counts of wilful attempted income tax evasion for the years 1954, 1955, and 1956, in violation of Section 7201 of the Internal Revenue Code of 1954 (Title 26 U.S.C. Section 7201), and also with three counts of making and subscribing joint income tax returns which were verified by a written declaration that they were

made under the penalty of perjury for the same years, 1954, 1955, and 1956, which returns the appellant did not believe to be true and correct as to every material matter, in violation of Section 7206(1) of the Internal Revenue Code of 1954 (Title 26 U.S.C. Section 7206(1)).[1]

The amounts alleged in the first three counts of the indictment were as follows:

INCOME

Year	*Reported*	*Corrected*	*Additional*
1954	$21,221.01	$ 33,993.64	$12,772.63
1955	20,796.96	32,664.03	11,867.07
1956	22,986.79	35,354.28	12,367.49
TOTALS	$65,004.76	$102,011.95	$37,007.19

TAX

Year	*Reported*	*Corrected*	*Deficiency*
1954	$ 5,743.60	$11,396.82	$ 5,653.22
1955	5,582.84	10,732.01	5,149.17
1956	6,414.98	12,007.37	5,592.39
TOTALS	$17,741.42	$34,136.20	$16,394.78

The material matter in the last three counts which appellant was alleged to have knowingly failed to disclose at the time he made and subscribed the joint income tax returns was that he and his wife had additional income of $12,801.45, $12,396.70 and $12,580.19 over and above that which he had reported for the years 1954, 1955 and 1956, respectively.

The trial of the case commenced on April 30, 1962, before District Judge Alfonso J. Zirpoli, and concluded on May 14, 1962, with a guilty verdict on all counts.

On May 25, 1962, Judge Zirpoli assessed a sentence

[1]Appellant's Opening Brief, Appendices, pp. i-vi, hereinafter referred to as "O.B.A. i-vi"; appellant's opening brief will be designated "O.B."

of imprisonment for one year and a $1,000 fine on Count 1, with the prison sentences on the five remaining counts concurrent with the one-year sentence on the first count.

Appellant's returns were prepared by his accountant (Joyce) from handwritten sheets (Exs. 58, 59, 60) recapping the items of income and the items of expense which were furnished to the accountant by appellant. (Tr. 280-284). The accountant never saw any of appellant's records in preparing the returns (Tr. 285). The sheets furnished by appellant to his accountant did not contain any of the omitted items of income (Tr. 282; 287-288) nor did the accountant know about any of the omitted items (Tr. 290-296). Appellant stated that he had no formal books; his checkbook was his means of recording his income; he would analyze the receipts and expenditures shown by his check book stub; he would then recapitulate these items and turn them over to the accountant for preparation of the return. When appellant received fees in a case he would make a note on his check book stub to reflect this income. Appellant knew he was on the cash basis. (Tr. 344-345, 591-592.)

The same accountant prepared the Tarman-Sherwin partnership returns; from the partnership returns, the accountant secured the income figures for appellant's individual returns (Tr. 602). The following amounts were reported on appellant's 1954, 1955 and 1956 returns as his share of this partnership income: $1,182.90, $2,891.71 and $5,281.88 (Exs. 1, 2, 3). Appellant was aware that a partner reported his income from a partnership in the year in which the partnership earned income whether he had received cash in that year or not (Tr. 344).

The agent who was examining appellant's returns, several times, beginning in September 1957, requested appellant's checkbook and checks to audit the income items, since this was appellant's only method of recording them. However, appellant did not furnish the agent any checkbook stubs from the Central Bank account for the prosecution years; also some twenty paid checks for 1956 alone were missing, appellant claiming they were lost (Tr. 356-357) despite the fact that appellant's return for 1956 (Ex. 3) had been prepared only a few months earlier, for which appellant stated he had used his checkbook (Tr. 769).

On several occasions, the agent asked appellant what bank accounts he had. Appellant reiterated each time that he only had two accounts, a trustee account for his law practice, at the Central Bank, and the account at the Oakland Bank of Commerce for his personal household matters, and that he had no other bank accounts. (Tr. 348, 350-354, 372.) Appellant in fact had other bank accounts: among them, a Beresa Corporation account in the Bank of America, Marvin Sherwin, Trustee (Exs. 31, 51, 56); and a Crocker-Anglo Bank Main Office, Oakland, account of Estate of Preston Beckwith, Marvin Sherwin, Trustee (Tr. 357-359). These accounts either had deposits or withdrawals of unreported income for the prosecution years. Appellant admitted that he had made numerous deposits to the Beresa account at the Bank of America which had nothing to do with Beresa business (Tr. 775, 796). For example, two of the Willows Commission checks in the amounts of $1,850 and $1,650 (Ex. 31; Tr. 154) were deposited to the Bank of America account on February 15, 1955, and August 22, 1955 (Tr. 476-484;

776, 790). Also the check for the unreported fee from the Beckwith Estate was drawn on the Crocker-Anglo bank account in Oakland. (Tr. 771.)

Another undisclosed bank account was one in the name of E. O. Thompson, at the American Trust Co., Oakland, which was used to deposit the proceeds from the sale of the property at 15 Myrtle Street to Mr. McGee. Appellant testified that the reason he opened the account in Thompson's name was because he was facing three or four lawsuits and, at that time, he was attempting to conceal this bank account from his creditors. There was other concealment with respect to this transaction. The mortgage which appellant took on the McGee property was recorded in the name of a realtor named Pleitner, even after the death of Mr. Pleitner. McGee's interest payments on the mortgage were among the items of appellant's unreported income. Again, appellant claimed that one of his reasons for keeping the property in Mr. Pleitner's name was because of the lawsuits he was facing (Tr. 759-765).

Appellant had practiced law from 1926 until September or October 1953 when he went on the bench as a judge of the Superior Court of California in and for the County of Alameda. From 1945 to 1953 appellant also served in the California State Assembly (Tr. 587-589). He was a member of its Revenue and Taxation Committee which writes all tax legislation for the State of California; he was also chairman of the Ways and Means Committee (Tr. 848-851).

From 1943 until 1949 appellant kept the books of the Tarman-Sherwin partnership and at least for the years 1945 and 1946 prepared and filed whatever partnership tax returns were filed. (Tr. 684-732.) Appellant con-

ceded that he knew the difference between capital gains and ordinary income and that he had frequently discussed the matter with his accountant (Tr. 735-736). Indeed, on the partnership returns for 1945 and 1946 (Ex. 71) which appellant prepared, there were capital gains computed and reported.

In response to the Bechtel Corporation accountant's request for advice with respect to the taxability of multiple corporations, appellant wrote a memorandum as to the state of the law so as to permit Bechtel Corporation to secure the benefits of lower taxation brackets for the corporations affiliated with Bechtel (Tr. 696-698). Later, in 1955 or 1956 when the Beresa Corporation was having tax troubles with the Government with respect to the several Beresa affiliated corporations, appellant gave advice to Beresa in the matter; in connection with this, appellant prepared and submitted a memorandum (Ex. 41) on behalf of Beresa concerning the tax advantages of multiple corporations (Tr. 233-237; 697-703) .

The evidence shows that the following specific items of income were not reported on appellant's tax returns (Exhibits 67, 68, 69; Tr. 448-475).

	1954	*1955*	*1956*
1. *Legal Fees*:			
Milo Ayers	$ 2,708.32		
Beckwith Estate (Executor Fee)	911.86		
Beresa, Inc.			
Cash	250.00		
Credit Card	669.78	$ 640.06	$ 320.39
Stock Anderson Hgts. Water Co.			10,000.00
Chip Steak Co.	3,833.07		
Crozier C. Culp	682.26	774.85	1,182.66
To others for Sherwin		838.66	
Nichols, Richard, etc. ...	2,807.71		
J. H. Tarman		500.00	

2. *Commissions*:			
J. H. Tarman	1,500.00		
Wright		9,350.00	
3. *Partnership Income*:			
Cheney Bros. Chip Steak Co.		192.71	150.73
Crozier Culp, Joint Venture		414.27	
4. *Interest*:			
Emanuel D. McGee	245.41	179.56	182.14
Series E. Bonds		148.15	
Director, I.R.S.		358.44	
5. *Dividends*:			
Melfort Company			1,744.27
Totals	$13,608.41	$13,396.70	$13,580.19

The following summarizes the evidence with respect to the unreported items:

1. Legal Fees

On his return for 1954, appellant reported "sale of law practice," $1,216.66. (Tr. 758-759.) Appellant told Agent Grappo on September 3, 1957, that he actually didn't sell his law practice, but he didn't wish to have his return disclose that he was receiving fees from law practice as he didn't want it to appear that he was engaged in law practice or receiving legal fees after he was a judge. (Tr. 349-350; 379-381.) The amount appellant reported was made up of a remittance for legal services from Milo Ayer of $1,166.66 and a guardianship fee of $50.00 (Tr. 455, 758). However, appellant actually received an additional $2,708.32, above that reported, from Milo Ayer for legal services which he admitted he did not report, saying that he could not state exactly why it was that he had not reported these additional amounts (Tr. 607-608, 758-759).

With respect to the legal fees received: (1) from Crozier C. Culp—constituting 12 checks (Exs. 16, 17, 18) over a three-year period (Tr. 38-44), (2) from the law firm of Nichols, Richard, Allard & Williams, totalling $2,807.71 and (3) from the Beckwith Estate (for Executor's fee) in the amount of $911.86, appellant admitted that he did not report them on his returns and that he knew at the time they were taxable, generally giving as his reason that he just overlooked them or that he just did not have them in mind (Ex. 7; Tr. 774, 807).

The first legal fee received from Beresa during the prosecution years was a $250 check (Ex. 35) which was "on account legal services" (Tr. 204, 208, 244). The second group of items concerned income to appellant in the form of purchases on Shell Oil Company credit cards for all three prosecution years. The credit cards were issued to Beresa and were further issued by Beresa to appellant for his use. Appellant agreed that these purchases on the credit cards constituted income to him and that he had not reported this income from Beresa. (Ex. 7; Tr. 802).

The third Beresa item concerned stock in the Anderson Heights Water Company which was transferred in 1956 to appellant in satisfaction of a $4,000 loan and appellant's $13,250 bill for legal fees owed by Beresa (Tr. 243, 245, 831). By comparing the per share cost to Mr. Wright and Mr. Wetenhall who had paid $25,000 for some of the Anderson stock a few weeks prior to the transfer to appellant, the Government's expert in computing appellant's income arrived at a $14,000 value of the stock, of which $4,000 represented repayment by Beresa to appellant of a loan. The $10,000

balance was considered income to appellant as satisfaction for the $13,250 legal fees bill (Tr. 470-471). Appellant testified that he did not report the Anderson Heights stock received on account of legal fees due him for two reasons: (1) he did not consider the receipt of stock a taxable item until sold because he believed only items of cash were reportable,[2] and (2) he considered the receipt of this stock a security transaction (Tr. 623-624).

A Chip Steak Company check dated January 4, 1954, for $3,833.07 was received by appellant for legal fees rendered in prior years; the fee was not reported on appellant's worksheet (Tr. 808) or on his 1954 return, although appellant agreed that it was an item of taxable income (Tr. 35). At the trial, appellant testified that he had undoubtedly recorded this check on his checkbook stub (Tr. 808) but he could not recall why he had not included the item (Tr. 608-609, 808).

The $500 check from the J. H. Tarman Corporation (Ex. 24) was a 1955 legal fee earned for the appellant's services rendered in Tarman's Suisun Gardens project (Tr. 56-58). Appellant contended that he thought this was either a partnership withdrawal or a gift (Tr. 785-787) even though the Suisun Gardens project was not a partnership enterprise (Tr. 65).

2. Commissions

A $1,500 commission was received in 1954 by appellant from the Tarmans, father and son, real estate operators, for services rendered in effecting the sale of

[2]However, with respect to partnership income, appellant told the agent that he was aware that a partner would report his income in the year in which the partnership earned the income, whether or not he had received the cash in that year (Tr. 344).

certain acreage near Willows, California, to the Beresa Company. The Willows acreage was not an asset of the partnership existing between appellant and J. H. Tarman. (Tr. 61-65.) Appellant similarly contended that he thought this was a partnership withdrawal (Tr. 834).

During the year 1955, appellant received commissions, referred to at the trial as the Willows Commission, totalling $11,000 from Milton A. Wright (Tr. 611-612) for acting as go-between for Wright with Beresa, Inc. and others in connection with arranging a badly needed loan between Wright and the Beresa corporation and for drafting the contract on March 18, 1954 (Tr. 152-159; 822-824).

Payment of $8,000 of this amount was effected by appellant cancelling the $8,000 balance as an offset against money which was owed Wright by a joint venture composed of Tarman, Sherwin and one Schneider. As Wright received payments from Tarman and Schneider in 1955, he turned them over to appellant, thereby completing the $11,000 payment. Appellant reported a $1,650 item on his 1955 return as being "income from former law practice" which has been considered as one of the Willows Commission checks; appellant has been given appropriate credit for this amount in the Government's computation of income (Ex. 68; Tr. 157-160, 463).

Appellant admitted that the worksheet (Ex. 57) which he turned over to the agent during the investigation had listed $6,350 for "Willows Comm," but that the sheet which he turned over to the accountant for preparation of the return contained nothing for this item (Tr. 611-612). Appellant testified that he could not give any reason why the work sheet he gave to the agent

contained only part of the commission (Tr. 818). Despite the fact that appellant had listed $6,350 as income on the sheet turned over to the agent, he nevertheless contended at the trial that he did not consider this receipt as income. The reason he gave was that while in form it was a commission it was really intended by Mr. Bechtel to compensate appellant for the losses he had sustained on the bankruptcy of the Bechtel Corporations (Tr. 612-614, 819, 821-822, 826, 862). Appellant did not offer any explanation as to why he was entitled to omit income from his 1955 return to compensate him for a 1951 stock loss in the bankrupt Bechtel Corporation which had no relation to the 1955 transaction involving the Beresa Corporation.

3. Partnerships

Appellant received some income from a partnership interest in Cheney Brothers Chip Steak Company (Tr. 113-116) and from the Crozier Culp joint venture (Tr. 46-47, 51-52). Appellant testified that Culp reported this item of income to him, but that he gave the matter no attention (Tr. 810). There were additional unreported partnership income items from dividends on the Tarman-Sherwin partnership-owned Melfort Company stock, discussed *infra.*

4. Interest

Appellant received regular monthly interest payments on a mortgage from Emanuel D. McGee. Every month McGee sent his loan payment receipt book (Ex. 8) to appellant, who would compute the interest which was due on the notes and make notations in the book as to the amount of the payment of principal and interest

(Tr. 261-262, 765-766). The mortgage itself was recorded under the name of one Pleitner. (Tr. 764-765). Appellant admitted that he knew the interest was reportable for each year (Tr. 768), explaining that he "just never gave it a thought" (Tr. 609). When appellant sold some Series E. bonds he received $148.15 interest, but did not report it; he testified that he did not know that such interest was reportable (Tr. 778). However, appellant had nevertheless included the bond principal and interest on the schedule of income (Ex. 57) given to the agent during the investigation and then had drawn a line through the item. (Tr. 777.) Appellant also received interest on a tax refund from the Government, but testified that he did not pay any attention to the fact that part of the refund was interest, even though there was a notation on the face of the notice to appellant (Ex. 12) that the interest was reportable (Tr. 779).

While appellant failed to report interest, nevertheless each year appellant claimed substantial amounts of interest expense on his returns (Exs. 1, 2, 3).

5. Dividends

The Melfort Corporation which owned shares of stock in the David Meat Company, distributed that stock to the stockholders of the Melfort Company (Ex. 26; Tr. 122). This distribution represented taxable dividend to the Melfort Company stockholders. Appellant's reportable share of this dividend was $1,844.27 (Tr. 472-474). The shares received by appellant in this distribution were placed in the name of appellant's daughter by appellant (Tr. 197). Appellant had suggested to the daughter that she report the dividend on her income tax returns; he arranged to have the

accountant Wright prepare her return (Tr. 194-195, 200). Accordingly, the daughter reported the dividend on her joint return reporting a total tax liability of $169.62 from this dividend and from other income. Appellant paid the tax on the daughter's return (Ex. 33; Tr. 195-196, 201). While appellant contended at this trial that the stock was his daughter's (Tr. 838), he had, however, at the Santa Rosa trial where the Tarman-Sherwin partnership litigation was taking place, made the flat statement that the stock was his (Tr. 848).

With respect to appellant's contentions at the trial that he was entitled to an operating loss carry-forward from the 1951 bankruptcy of the Bechtel Corporations, the evidence showed that on appellant's 1951 returns (Exs. 63, 64) he had claimed an operating loss on a *loan* made to the Bechtel Corporation, but had claimed only a *capital loss* with respect to the loss on his *stock* investment in the bankrupt Bechtel Corporations. In his 1952 return (Ex. 65), he had carried forward this loss from the Bechtel stock and again merely claimed the maximum allowable capital loss of $1,000. On none of his returns had appellant claimed an *operating loss* on account of his stock loss resulting from the bankruptcy of the Bechtel corporations.[3]

In a letter dated April 13, 1954 (Ex. 75) in connection with appellant's 1951 returns, the Internal Revenue Service had requested substantiation of appellant's claim to being in the business of promoting corporations; appellant was also requested to furnish details as to the

[3]Appellant's own expert at the trial admitted that in the 1958 return of appellant which he had prepared he had treated appellant's loss resulting from payment of $1,487 in 1958 to the Bank of America as a guarantor on an obligation of the defunct Bechtel Corporation as a *capital* loss to appellant and that he had also treated 1959 and 1960 similar losses in the same way (Tr. 967-970).

claimed $21,115 operating loss and the $30,000 capital loss. To substantiate his assertion on his 1951 return of being in the business of promoting corporations, so as to warrant his claim of $21,115 operating loss on the loan, appellant listed twenty-seven corporations he had formed. With respect to the $30,000 *capital* loss claim, appellant explained to the Internal Revenue Service that this pertained to his loss on the *stock* of the Bechtel corporations (Ex. 75).

Thereafter, based on appellant's representations in his letter, an office auditor in the Internal Revenue Service (Tr. 1004) allowed the $21,115 operating loss claim for the loan on a "tentative adjustment" or what is called a "quickie claim." This is allowed, based solely on the taxpayer's statement without examining the return and without any additional investigation (Tr. 1009-1010). The purpose of the law is to permit the taxpayer to get his money back quickly from the federal government if he needed it (Tr. 1016). Such claims were processed at the rate of three to four hundred a week per one employee (Tr. 1010). There was no final agreement as to the correctness or incorrectness of such an allowance (Tr. 1011; 1015-1016).

At the trial it was established through appellant that there were actually just two corporate groups. The Bechtel Corporation family which constituted the first twenty-three corporations on the list submitted to the Internal Revenue Service (Ex. 75) and the Chip Steak Company, which was made up of the last four corporations on the list. The twenty-three in the Bechtel family of corporations were associated in the same general enterprise of building subdivisions (Tr. 634-635; 691-693, 721). Appellant testified that he guaranteed some

of the financing for Bechtel Corporation; however he admitted such guaranteeing was done jointly with T. R. Bechtel, the other major stockholder (Tr. 716-717). Appellant testified that the purpose of forming the multiple Bechtel family corporations was to secure tax benefits and so that a new subdivision would not be impeded in case one tract (in a separate corporation) was having financial difficulties (Tr. 696-697). In the Bechtel family of corporations the stockholders were the same; the offices were the same; and none of the subsidiary corporations had any employees (Tr. 721-724). Appellant had been receiving a salary from Bechtel (Tr. 726). Appellant testified that the first time he had known that he had been listed on his 1951 return as a promoter of corporations was at this trial (Tr. 749). None of his Bechtel stock had been sold by him to anyone and he had no intention at any of this time to sell any of the stock (Tr. 750).

At the trial, the government expert in making his computation allowed as a deduction from income the maximum $1,000 as a capital loss carry-over from the 1951 return for each of the prosecution years (Exs. 57, 58, 59; Tr. 486).

The Court instructed the jury at length with respect to the claims of the appellant and the government on the question of whether the losses sustained by the defendant by reason of the 1951 bankruptcy of T. R. Bechtel Company and Bechtel Lumber Company were net operating losses in a business of the appellant or a loss from the sale or exchange of capital assets. The Court further instructed the jury that it was for them to determine whether the loss was an operating loss or a capital loss to the appellant. (App. xix-xxiii).

QUESTIONS PRESENTED

1. Whether the questions asked with respect to legal fees to establish that the checks and stock received by appellant constituted income and not partnership drawings or gifts to him were warranted.

2. Whether the Government properly computed appellant's tax basis in Anderson Heights stock, which appellant had received in settlement of a bill rendered for legal services.

3. When the evidence showed that there was in fact additional unreported income from the Tarman-Sherwin partnership, whether the questions propounded by the prosecutor and the instructions given by the Court with respect to this additional income were proper.

4. When Agent Neilands was called as a witness by the defense and testified fully with respect to his audit of the Tarman-Sherwin partnership, whether the defense was entitled under any theory of law to have produced the agent's report of his audit of the partnership.

5. Whether the elements of the offense in Section 7206(1) are the same as those in Section 7201.

   (a) Whether the Government was required to elect between the Section 7201 and Section 7206(1) counts of the indictment.

   (b) Whether the Government must prove a tax due and owing with respect to the Section 7206(1) charges.

(c) Whether the matters alleged in the indictment with respect to the Section 7206(1) charges were material within the meaning of Section 7206(1).

(d) Whether the Court's instructions on wilfulness with respect to the 7206(1) charges were proper.

6. Whether the Court's instructions on wilfulness and intent with respect to the Section 7201 charges were proper.

7. When appellant relied entirely on one theory of defense at the trial with respect to alleged losses and when the evidence at the trial related solely to that one theory, whether the Court was required to instruct the jury concerning any other theories about which there was no evidence in the record.

8. Whether there was any sound basis in the trial record to require the Court to hold as a matter of law that there was no tax due and owing by appellant with respect to the prosecution years.

SUMMARY OF ARGUMENT

There was no error in the questions and answers concerning legal fees earned and received by appellant during the prosecution years. The evidence was plain that appellant had in fact earned such fees during the prosecution years. The testimony with respect to legal fees was necessary in order to establish that the fees were items of income and not drawings or gifts as variously contended by appellant. So long as the evidence was probative of the issues in this case, it does not become inadmissible merely because it may also

show the commission of another offense. *Himmelfarb* v. *United States,* 175 F.2d 924, 941 (C.A. 9th, 1949), *cert. den.,* 338 U.S. 860. The Court carefully instructed the jury as to the limited purpose for which such evidence was received.

The computation of appellant's unreported income from the transfer to him of the Anderson Heights Water Company stock was based on the per-share price paid by another purchaser (Wright) at about the same time as the transfer to appellant. The government's expert carefully deducted from the income charged to appellant the proportion of the stock which represented repayment of a $4,000 loan. The price at which Wright had purchased the stock was subject to the condition that the sellers would repurchase at an $8,000 bonus. However, appellant concedes that the seller, the Beresa Corporation, was in financial difficulties at the time. Therefore, the buyer (Wright) had no collateral to look to except the stock he was purchasing. Following the transfer of the stock to appellant, the latter actually purchased more stock in the Anderson Company from one Rarey at a higher price than Rarey had paid. Moreover, Wright later in 1958 looked over the Anderson project prospect and found it to be good and offered to buy appellant's stock, but appellant was not interested in selling. Accordingly, the government was warranted in assigning a $14,000 base to this stock. This stock was transferred to appellant in settlement of a $13,250 legal fee bill; however, the government used the lesser basis of $10,000 ($14,000 less the $4,000 which represented repayment of a loan) in charging appellant with this income.

The questions asked about unreported income from

the Tarman-Sherwin partnership were warranted since appellant, his counsel, and all witnesses who had knowledge on the subject agreed that there actually was income from that source which had not been reported. In fact there was evidence of specific items of unreported Tarman-Sherwin partnership income received from dividends in the Melfort Corporation which appellant knew about and the accountant who prepared the returns did not know about and which was not reported on the partnership return or on appellant's return. The Court's instruction on the issue properly advised the jury that it could consider such evidence with respect to unreported Tarman-Sherwin partnership income "if from the evidence you are satisfied beyond a reasonable doubt that he failed to report such income."

With respect to appellant's complaint that he was prevented by the Court from showing partnership losses, the record is clear that the Court's refusal to permit cross-examination of a witness on this issue occurring during the government's case was carefully premised on the fact that the questions were beyond the scope of the direct testimony of the witness and pertained to matters discovered during post-prosecution years. As was pointed out (Tr. 320), such evidence would be material if the witness were called as part of appellant's case.

There was no error in refusal of the Court to order production of Agent Neilands' report (Court's Exhibit No. 1). This agent had conducted an audit of J. H. Tarman, Sr., a part of which included an audit of the Tarman-Sherwin partnership. However, the agent was not an investigating agent on this case. The agent's report was not admissible *per se* as evidence. *United*

States v. *Brockington,* 21 F.R.D. 104 (E.D. Va. 1957). The agent was called as a witness for the defense and testified fully as to the audit he had conducted and as to his computations. There were no questions asked of him which he failed or refused to answer. The government did not dispute the agent's testimony in any way. There was thus no principle of corroboration, impeachment, refreshment of recollection or other basis in law warranting production of the report.

The sentences on all counts being concurrent, if this Court finds that appellant's conviction on the Section 7201 charges should be upheld, it is unnecessary for this Court to consider appellant's various allegations of error with respect to the Section 7206(1) charges. *Hirabayashi* v. *United States,* 320 U.S. 81, 105 (1943).

The appellant erroneously assumes that the offense defined in Section 7206(1) is the same as that set forth in Section 7201. The offense charged in Section 7206(1) is merely an incidental step in the consummation of the offense of attempted tax evasion proscribed in Section 7201. Hence, the government, having had the right to proceed against appellant under any section or sections of the Internal Revenue Code that it selected, was not required to elect as between the 7201 and 7206(1) counts of the indictment, nor was it required, with respect to the 7206(1) counts, to prove a tax due and owing. Similarly, appellant was not entitled to an instruction that he have a tax evasion intent with respect to the 7206(1) charges. The Court's instructions as given on wilfulness as they related to the Section 7206(1) charges were proper.

The indictment alleged materiality within the meaning of Section 7206(1) with sufficient particularity. A

false statement regarding the items of appellant's income is obviously material within the purview of Section 7206(1).

There was no error in the trial court's instructions on wilfullness and intent with respect to the Section 7201 charges of tax evasion. The full and comprehensive charge by the court on that subject was proper. The appellant himself requested the so-called *Murdock* instruction which comprises substantially all of the charge complained of. Of the two decisions of this Circuit relied upon by appellant on this point, one is clearly distinguished by reason of the setting in which the instruction there held to be erroneous was given; while the vitality of the other has been virtually eliminated by a subsequent decision of this Court. Furthermore, the language of the instructions given in this case about which appellant complains was not the same as that used in the instructions given in the cases upon which appellant relies to support his contentions. From a reading of the instructions as a whole, and in context, it is clear that appellant's allegation of error with respect to the Court's charge has no merit.

There is no merit to appellant's contention that he was entitled to instructions on some other alternative theories of the defense. At the trial, there was testimony about and appellant relied on only one theory, that he was a dealer in and promoter of corporations, to support his contention that he was entitled to a carry-forward loss during the prosecution years on account of his loss on the stock of the Bechtel Corporations as a result of their 1951 bankruptcy. The Court carefully instructed the jury on appellant's theory. The Court was not warranted in charging the jury with respect to

some other defensive theory which appellant had not relied on and about which there was no probative evidence in the record.

There is no merit to appellant's final contention that the Court should have held as a matter of law that no tax was due and owing by appellant. Contrary to appellant's assertion in support of this claim (O. B. 59-65), the government through the Internal Revenue Service at no time conceded that appellant had an *operating loss* on the bankrupt Bechtel Corporation *stock* which appellant was entitled to carry forward to the years 1954, 1955 and 1956. Indeed, appellant had specifically claimed only a *capital loss* with respect to this stock loss on his 1951 and 1952 returns.

ARGUMENT

I. The Legal Fee Testimony Elicited Was Necessary in Order to Establish the Fees as Items of Income.

Appellant contends (O. B. 13-20) that the introduction of testimony and the questioning of the prosecutor with respect to the earning of legal fees during the prosecution years by appellant was error. This contention is without merit. A great deal of the unreported income in this case arose from legal fees which were not declared on appellant's tax returns. The mere fact that during a taxable year a person receives cash or checks or other things of value does not establish them *per se* as items of income to be reported on the taxpayer's income tax return. In this case, the introduction of testimony with respect to receipt by appellant of legal fees was necessary to establish these items as income and, further, to rebut appellant's contention that

some of them constituted non-income receipts such as withdrawals from a corporation or partnership.

One of the questions and answers about which appellant complains (O. B. 14-15) concerns the testimony of the witness Jack Tarman about a $500 check to appellant (Ex. 24). The Tarmans and Sherwin were in a partnership together. It was necessary to establish that this check represented income, namely payment for legal services for the Tarmans, and not a drawing from the partnership—a non-income receipt. The witness had just testified that appellant had asked for $500 for appellant's help in alleviating the intricate problems the Tarmans had had with the other owners in the Suisun Gardens project; the witness testified that appellant had asked that Tarman tell Joyce, the partnership accountant, to put the $500 in the journals and ledgers as a partnership withdrawal (Tr. 59). It was thus not clear whether the $500 check was a partnership *withdrawal* (a non-income item) or a payment from the J. H. Tarman Company on account of legal services rendered to it. Accordingly, the witness was properly questioned as to whether the payment was for services "in the nature of legal assistance" (Tr. 57).

The witness later stated that the $500 item was first put on the journal sheets as a Gwin Unit transaction and was ultimately entered on the books and records of the J. H. Tarman corporation as a legal fee and deducted as a corporate expense (Tr. 60; 96-101) and that the Suisun Gardens project for which the service was rendered was not a Tarman-Sherwin partnership project (Tr. 65). The bank account on which the check was written was the Tarman Corporation account (Tr. 96).

The necessity to definitely establish the income character of the item was made plain when appellant on the witness stand said that he considered the check either (1) as a partnership withdrawal, or (2) as a *gift* made by Mr. Tarman in appeciation of appellant's services on the Suisun matter (Tr. 785-787). Appellant never listed the $500 check as constituting partnership withdrawal, in his accounting of his partnership interests at the Santa Rosa litigation (Tr. 787-788). It would seem that if appellant had actually intended that the item be charged against him as a partnership withdrawal and believed that it had been handled in that way, and that it was not payment for legal services rendered to the Tarman Company, the item should have been listed in his accounting of his partnership interests at Santa Rosa.

Appellant additionally contends that a $1,500 check from the Tarmans was not income, on the grounds that appellant requested that it also be treated as a withdrawal from the Tarman-Sherwin partnership (O. B. 16-17). However, Jack Tarman testified that he had issued the check to appellant as payment for legal services or commission expense (Tr. 92) for appellant's services in effecting a sale by J. H. Tarman of Tarman's subdivision in Willows, California, to the Beresa Corporation and in typing up the contracts for the sale, pursuant to a telephone call he received from appellant requesting to be paid $1,500 for his services. The Tarman-Sherwin partnership had no connection with the Tarman's Willows subdivision or with Beresa, the two groups involved in the Willows subdivision sale. (Tr. 61-64; 92-95; 107.) The notation "Willows deal Beresa" was put on the check when it was returned from the bank and before it was delivered to the

accountant for preparation of the income tax returns (Tr. 93, 107) which, of course, were prepared long before the witness' testimony at this trial.

Some of the questions directed to *appellant* about which he complains (O. B. 18; Tr. 785; 805-806) were proper on another ground. When appellant took the stand, he gave a different account (Tr. 614-616; 834-836) as to his conversations with respect to the $500 and $1,500 Tarman checks than had the witness Jack Tarman (Tr. 53-66). Accordingly, the credibility of the government witness became an issue, and it was probative to cross-examine the defendant as to the details of the transaction as had been testified to by Jack Tarman.

Appellant further contends (O. B. 18-19) that he was prejudiced by questions asked with respect to legal fees paid him by Beresa. Appellant was not a stockholder or officer in Beresa, but did perform legal services for it (Tr. 204) and was advising Beresa during the prosecution years (Tr. 231). Thus, in 1955, appellant prepared and submitted a memorandum to Beresa (Ex. 40) with respect to their proposed business activity in Oregon, advising them of the legal requirements for doing business in Oregon, suggesting the advisability of using a California corporation, and offering to prepare the necessary forms for setting up the corporation which he would forward to Beresa to execute.

There were several items of income charged by the government as having been received by appellant as income from Beresa during the prosecution years, including (1) a $250 check "on account legal," (2) appellant's enjoyment of the use of Beresa's credit cards with Shell Oil Company, and (3) $10,000 worth of stock in the Anderson Heights Water Company which

was transferred to appellant in satisfaction of a $13,250 bill for legal fees owed by Beresa to appellant (Tr. 243-245).

On direct examination, the witness Reilley had said that the Anderson Heights Water Company stock was transferred to appellant in payment for legal fees (Tr. 245). The issue about which appellant now complains (O. B. 19) was actually brought up by appellant's attorney on cross-examination. Appellant's counsel had elicited from Mr. Reilley, a government witness, that the type of service performed by appellant after he went on the bench was such as arbitrating disputes (Tr. 252-253). Appellant's counsel also questioned the witness as to whether he had "found any other checks [other than the one for $250] for legal services that were paid to Judge Sherwin in 1954, 1955 and 1956." The witness replied that there were none because the total indebtedness had been wiped out by the transfer of the Anderson Heights Water Company stock (Tr. 254). In this setting, then, on re-direct, the witness was asked whether appellant performed legal services for Beresa during 1954, 1955, and 1956. The witness replied that appellant rendered services by advice and suggestions on how to conduct business, that he recalled that appellant also drew up a waiver of lien and items of that nature and that during 1954, 1955 and 1956 appellant had advised Beresa on tax matters (Exs. 40, 41; Tr. 255-259). Thus, the questions had been asked by the government on re-direct of witness Reilley to clarify his testimony.

Moreover, the need to establish the definite character of the receipt of the Anderson Heights Water Company stock as being reportable income from legal fees was shown when appellant's counsel moved to strike the

evidence with respect to this matter on the grounds, *inter alia,* that the government had not shown that the stock "constituted income to the defendant" (Tr. 524). In addition, appellant later gave two alternative explanations for nonreporting: (1) he considered this stock as a security transaction and not reportable, and (2) he did not consider receipt of stock a taxable item until it was sold (Tr. 623-626).

We believe the evidence shows another example in which appellant in effect admits earning income during the prosecution years from legal fees. Appellant was attorney for Chip Steak Company. Originally he was paid fees when he rendered bills; later he "was somewhat on a retainer on the basis of salary"; he continued on salary with the Chip Steak Company after he went on the bench. In connection with his explanation of the Chip Steak Company salary (actually reported on appellant's returns), appellant made the following statement with respect to rendering legal advice after he went on the bench: "Well, I think that any director in discusing company problems renders legal advice, but if there was anything involved taking any legal responsibility, I told them they would have to get some attorney who would be able to carry out what he advised. * * * I didn't give any legal advice on any matter that I thought might involve them in difficulty. I advised them to go to other attorneys. * * * but I didn't render any bills. My definition, of course, of practicing law or practicing medicine is either giving legal or medical advice for a compensation." (Tr. 708-712.)

The court carefully instructed the jury as to the limited purposes for which the evidence as to legal fees

was received and cautioned them to make no other use of the testimony, both during the trial (Tr. 806) and at the time the case was submitted to it (App. xi-xii):

> "I further instruct you that should you find that the defendant received fees for legal services rendered after he took judicial office, he is not here on trial for such conduct, nor is he on trial for any other act or conduct not alleged in the indictment. Any fees received by the defendant after he took judicial office, should you be satisfied that such fees were in fact received, for the purposes of this trial, are to be treated the same and no different than any other income received by the defendant from any other source. The fees and other income received, and not the source thereof, are material to this case, to the degree that you find such fees and other income go to make up the income of the defendant which was subject to tax during the years in question."

It has long been settled that evidence probative of an issue in the case does not become inadmissible because it also may show the commission of another offense. *Wood* v. *United States,* 41 U.S. 341, 360 (1842); *Strader* v. *United States,* 72 F. 2d 589 (10th Cir., 1934); *Tinkoff* v. *United States,* 86 F. 2d 868, 879 (7th Cir., 1936), cert. denied, 301 U.S. 689; *Himmelfarb* v. *United States, supra.*

We submit that there was no error in the questions asked and answers given with respect to appellant's earning of the legal fees during the prosecution years.

II. There Was No Error in the Treatment of the Anderson Heights Water Company Stock.

Appellant had performed legal services for the Beresa Corporation and had billed them for $13,250. In addi-

tion, he had loaned Beresa $4,000. In settlement of both of these obligations aggregating $17,250, Beresa transferred to appellant stock in the Anderson Heights Water Company. The total Anderson Heights capital stock had a par value of $75,000 and the actual cost to construct the Anderson Heights Water Company project was around $70,000 (Tr. 227). Mr. Wright testified that he had paid $25,000 for some of the stock pursuant to a contract to sell (Ex. 27) which called for purchase of all of the Anderson stock for $40,000; the buyers had the option to purchase only part of the stock at the proportionate price, which they exercised to the extent of $25,000 worth.

The government computed appellant's interest in Anderson on the basis of the per share cost to Wright in his purchase of the Anderson stock which had occurred only a few weeks before appellant's transaction. (Tr. 130, 470-471). Based on the Wright purchase, the value of appellant's stock in Anderson was computed at $14,000. However, the government's expert in making the computation first deducted the $4,000 due appellant on the loan, since this did not represent income. The remaining $10,000 basis was charged as income to appellant. (Tr. 470-471.) The government's expert stated that there were several ways in which the basis for this stock could be computed. It could be computed by the fair market value, which was what a willing buyer would pay a willing seller. In the absence of any history of willing buyers and willing sellers it is assumed under the Internal Revenue Code, in the absence of satisfactory evidence to the contrary, that the asset has the value of the claim. (Tr. 522-523.) In this particular case the claim would be $17,250, a $4,000 loan and

$13,250 for legal fees. Here, the government, however, took the lesser figure of $10,000 as the basis for that part of the transfer of stock attributed to appellant as income from legal fees.

Beresa was owned by the Bechtels and Reilleys (Tr. 125, 152, 167). Wright was not a stockholder in Beresa. Wright's agreement to purchase the stock for $40,000 contained two conditions: (1) an option to *appellant* to purchase the stock for $48,000, and (2) in the event appellant did not exercise his option, an agreement by the Beresa interests to repurchase the stock at the option price of $48,000 (Ex. 27). Appellant later purchased additional Anderson Heights Water Company stock from one Rarey; the latter had purchased the stock for $1,000, at the same per-share price paid by Wright (Tr. 131, 470), and appellant paid him over $1,100 for it. (Tr. 832.) Thus, appellant must have thought at about this time that the stock was worth the $17,250 which was due him since he had secured the option to purchase Wright's $40,000 stock for $48,000 and later paid Rarey a premium to secure Rarey's stock.

Wright, who stated that in 1958 or 1959 he had looked over the Anderson records and thought things were getting better, had a short discussion with appellant about buying appellant's interest in Anderson, without mentioning price, and found out that appellant was not interested in selling (Tr. 131-133; 149-150). Apparently appellant still felt in 1958 that he had a good investment in the Anderson stock.

The only collateral which Wright had received for his $25,000 investment was the Anderson stock. Appellant states (O. B. 21) that Beresa, who had guaranteed performance on the Anderson contract (Ex. 27), was

in serious financial difficulties. If it is true that Beresa was then in difficulties, Wright had to depend on the value of his Anderson stock to protect his investment. Wright was purchasing *Anderson* stock, not *Beresa* stock. Wright was not a stockholder in Beresa and was plainly dealing at arms length with Beresa in negotiating the Anderson contract at the agreed-on price.

The Court properly instructed the jury that the burden was on the government to prove that the stock had the value claimed by the government. The relevant factors for the jury to consider in determining whether the government's computation of income to appellant from receipt of the Anderson stock were fully set forth in the court's instruction (App. xii-xiii). There was no need to instruct the jury that the $4,000 must first be deducted in arriving at appellant's base for tax purposes, as contended by appellant (O. B. 23-24), because the government's expert had at all times conceded this fact (Tr. 469-471, 504) and had deducted the $4,000 before arriving at the amount chargeable as income (Ex. 69).[4]

It has, of course, been long established that it is not necessary that the government prove an evasion of all of the tax charged; it is sufficient if it proves that any substantial portion was attempted to be defeated. *United States* v. *Johnson,* 319 U.S. 503; *Gleckman* v. *United States,* 80 F. 2d 394 (8th Cir., 1935) cert. den., 297 U.S. 709; *Tinkoff* v. *United States, supra.*

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[4]When appellant made his objection to the court's instruction, the Court pointed out that under the last sentence of defendant's proposed instruction No. 40 on this issue (O.B.A. xx), (which stated that the court "specifically instruct you that you *must find*" that the transferred Anderson Heights stock "had a value in excess of $4,000."), would have automatically instructed the jury that the Anderson Heights stock was an item of reportable income, and the court stated it did not want to go that far. (Tr. 1053-1054).

In this case, the Court properly left to the jury the issue as to whether the government had proved substantial unreported income from the acquisition of the Anderson stock. (App. xii-xiii). We submit that there was probative evidence to support the jury's findings under the court's instruction that appellant received substantial unreported income in 1956 from his acquisition of the Anderson Heights Water Company stock.

III. There Was No Error in the Treatment of Income From the Tarman-Sherwin Partnership.

There is no merit to appellant's complaint (O. B. 25) with respect to the question asked by government counsel as to whether there was additional partnership income or the witness' reply that there was additional income. This question was asked on cross-examination of Agent Neilands offered by the appellant during presentation of appellant's defense. Earlier, during the government's case, appellant's own counsel had stated in the jury's presence that certain items of Tarman-Sherwin partnership income had not been included in the income tax return of appellant (Tr. 314) and had vigorously pressed to be allowed to cross-examine Mr. Joyce on this issue (Tr. 310-330). The Court's refusal to permit such cross-examination at that juncture was based on its ruling that counsel could not go beyond the scope of the direct examination of Joyce, which had related solely to the preparation of appellant's returns (Tr. 315, 322, 328-330). The Court stated however that this matter was a proper subject to be brought out on appellant's case (Tr. 322). Moreover, the question about which appellant now complains was not objected to by appellant's counsel at the time it was asked (Tr.

576-577), which is hardly surprising in light of appellant's earlier efforts to secure the admission of such testimony. Nevertheless, it is now too late to be assigning this question and answer as error (Specification No. V).

Appellant's assertion (O. B. 27; see also O. B. 25-26) that the undisputed evidence in the case showed that in no way could appellant be held responsible for any unreported income from the Tarman-Sherwin partnership is not correct. It is true that appellant's income from the partnership which was reported on appellant's returns was taken by the accountant Joyce from the partnership returns. However, appellant had 202 shares of Melfort Company stock which he kept in his daughter's name; 100 shares of this stock actually belonged to the Tarman-Sherwin partnership (of which appellant had a 50% interest) and 102 shares belonged to appellant individually (Ex. 34; Tr. 203, 472-474). The accountant for the Tarman-Sherwin partnership (Joyce) who also prepared appellant's tax returns for the prosecution years testified that he did not know that the partnership owned stock in Melfort or that the partnership had received any dividends from the Melfort Company. Accordingly, the partnership dividends from Melfort had not been included in the partnership return or in appellant's individual return as income from the partnership (Tr. 290-292).

Nor was there error in the Court's instruction on the issue. The Court carefully advised the jury that it could consider evidence of unreported income with respect to the Tarman-Sherwin partnership providing "from the evidence you are satisfied beyond a reasonable doubt that he failed to report such income." (O.B.

25-26, App. xiv). As the Court pointed out when appellant objected to the instruction (Tr. 1130-1131), it had conditioned the Tarman-Sherwin partnership instruction on the premise: "if you so find" that there was any unreported income. The instruction was clearly warranted in light of the evidence.

There is no merit to appellant's further contention (O. B. 26) that the Court would not permit evidence of Tarman-Sherwin partnership losses to be introduced. At the time the offer of proof was made on this issue it was specifically stated by appellant's counsel to be as to after discovered evidence not known for some time after the returns for the prosecution years were prepared. The Court carefully noted that it denied the motion to elicit this testimony on the grounds (1) that counsel had emphasized that this was after discovered evidence, and (2) the proof was tendered as part of the cross-examination of this witness whose testimony on direct had been strictly limited to the preparation of appellant's returns (Tr. 328-329). As was pointed out (Tr. 320), the witness, appellant's own accountant who prepared his returns, could be recalled on appellant's case, at which point the questions would be material. *Chevillard* v. *United States,* 155 F. 2d 929, 934-935 (9th Cir., 1946).

No proof was offered on appellant's case as to any alleged Tarman-Sherwin partnership losses,[5] although the accountant-bookkeeper for the partnership (Joyce),

[5]We are at a loss to understand appellant's position (O.B. 26) that he wanted to go into partnership *income* for the purposes of determining *losses.* At the trial, appellant similarly contended that he was attempting to prove that the omission on appellant's return of certain partnership income, namely the Plaza Building, constituted a loss to the defendant (Tr. 322, 328). Apparently appellant contends that he should be entitled to a loss on his tax return for income that he never reported in the first place.

the person whom appellant had attempted to cross-examine about it, was available as a witness. The partnership records were, of course, subject to subpoena. Appellant's present accountant (Moran) who had just recently audited the Tarman-Sherwin partnership was put on the stand by appellant, and testified as to his computation of losses as a result of the 1951 Bechtel Corporation bankruptcy (Tr. 886-906), but said nothing about any alleged partnership losses he found in the audit.

IV. The Refusal of the Court to Order the Revenue Agent's Report Produced Was Not Error.

Revenue Agent Neilands was called as a witness by the defense. In 1958 and 1959 he had conducted an audit with respect to J. H. Tarman, Sr., in connection with which he had audited the Tarman-Sherwin partnership (Tr. 545, 561). He was not an investigating agent in connection with bringing the indictment in this case. Appellant had asked for production of the agent's report prior to trial and during the course of Neilands' testimony at the trial (Tr. 561). The Court refused to require pre-trial production on the grounds that the report was not evidence and was not producible under Rules 16 and 17(c), F.R.Cr.P., citing *United States* v. *Brockington, supra* (Tr. 528). The Court sealed the report and marked it Court's Exhibit No. 1. The Court likewise refused production of the report during the trial on the same grounds (Tr. 561-562); however, the Court had advised appellant that if the witness needed these workpapers and report to refresh his recollection they would be produced (Tr. 529-530). No such occasion arose.

As a witness for the defense, Agent Neilands identified the Tarman-Sherwin partnership balance sheet (Ex. G) which he had prepared (Tr. 550). He testified as to how he had arrived at the values used on the balance sheet (Tr. 551-560). His balance sheet listed the fair market value of the stock of the Bechtel Company and its subsidiaries at $300,000 (Tr. 556, 560) and the cost of the Plaza Building at $155,334 (Tr. 557, 564) and its fair market value at $200,000 (Tr. 559). Neilands testified that he arrived at the $300,000 fair market value of the Bechtel Corporation from appellant's own appraisal (Tr. 567). Neilands further testified that appellant's basis in the Bechtel Company stock was $58,320 to be used when and if appellant sold the stock or sustained a loss on it (Tr. 573-574). This figure was arrived at by allocating to the Bechtel stock a proportionate share of the over-all cost of the Tarman-Sherwin partnership assets of which this was a partial liquidation (Tr. 570-572). On his 1951 returns (Exs. 63, 64), appellant himself had used a $60,000 basis for the Bechtel stock when he claimed a capital loss. The agent stated that he agreed with appellant's $60,000 figure as it was close to the agent's $58,000 figure (Tr. 575-576). Neilands' testimony thus established precisely the basis he used in computing appellant's interest in the Bechtel Corporation. Appellant's complaint (O. B. 28-29) that he needed the agent's report for this purpose is therefore without merit. The agent was also specifically asked whether or not he took into consideration cash and other contributions to be made by appellant. The agent stated that he had not, and set forth the reasons why he had not done so. The agent described fully what he had considered in arriving at his valuation of appellant's

Bechtel interests (Tr. 578-585). Accordingly, there is no ground for appellant's complaint (O. B. 30-31) that he needed the agent's report to establish the basis of the agent's explanation of his computation of the loss.

The facts about which the agent testified were not disputed by the government and there was thus no need to rehabilitate the witness with corroborative evidence from his report. Moreover, appellant clearly could not demand production of the report to impeach his own witness. Nor did appellant attempt to show hostility of the witness or surprise so as to warrant suspension of the ordinary rules for impeachment. There was no showing that the witness needed the document to refresh his recollection. And under no theory could the report of the agent as such be admissible in evidence, as it had no evidentiary value standing alone.

There is no merit to appellant's contention (O.B. 30-31; see also O.B. 27) that he was crippled in making his defense by the non-production of the report. As we have shown above, the agent actually testified as to any aspects of his investigation about which he was questioned. As we said in point III, *supra,* the accountant (Joyce) who had prepared appellant's income tax returns (Tr. 281) was the person who kept the partnership records (Tr. 301). He was available as a witness for the defense but was not called by appellant, and the partnership records were subject to subpoena by the appellant. Furthermore, appellant did produce as a witness his own accountant (Moran) whom he had engaged to conduct an audit of the Tarman-Sherwin partnership (Tr. 924) and who testified extensively to appellant's interest and losses in the Bechtel Corpora-

tions (Tr. 872-889) and as to his computation of losses on the Tarman-Bechtel interests (Tr. 895-909).

Appellant was clearly not deprived of any right by the non-production of the report; he was not entitled to it under any theory of law. We submit that the Court was correct in ruling that the agent's report should not be produced.

V. The Court's Rulings and Instructions With Respect to Counts Four, Five, and Six Concerning Section 7206(1) Were Correct and Did Not Constitute Error.

The prison sentences assessed on all six counts are to run concurrently, and the sentences assessed under the Section 7206(1) charges are no greater than the sentences under any one of the Section 7201 charges. For this reason, it is unnecessary for this Court to review the convictions on the Section 7206(1) charges and the contentions made by appellant with respect to those charges, provided it finds that the conviction of appellant can be upheld on any of the 7201 charges. *Lawn* v. *United States,* 355 U.S. 339, 362 (1957); *Hirabayashi* v. *United States, supra*; *Pinkerton* v. *United States,* 328 U.S. 640 (1946); *Sinclair* v. *United States,* 279 U.S. 263, 299 (1929); *Cohen* v. *United States,* 201 F.2d 386, 393 (9th Cir. 1953), *cert. den.*, 345 U.S. 951. We believe it is clear that there was no error with respect to the conviction of appellant on the 7201 charges.

However, since appellant has made divers allegations and has devoted a great number of his assignments of error to his contentions with respect to the Section 7206(1) charges (O. B. 32, 33-35, 42-48, 48-51, 51-55), we have nevertheless attempted to answer each of the separate contentions made by him. Because many of

appellant's contentions are intertwined and overlapping, they will be considered together.

General

The gist of the offense described in Section 7206(1) is the wilful subscription by a taxpayer of a return which is made and signed subject to the penalties of perjury, when the person signing the return knows the return not to be true and correct as to every material matter.

In creating the forerunner to Section 7206(1) Congress was retaining the effect of the perjury statute which became inapplicable to tax returns by reason of the coincidental elimination of the requirement that such returns be made and signed under oath. *Cohen* v. *United States, supra.*[6]

Enactment of Section 7206(1) accomplished no limitation on the allegation of the filing of a false return as a means of attempted evasion under Section 7201 because the offense of making and subscribing is distinct

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[6]The statute referred to in *Cohen* is Section 3809(a) of Title 26, United States Code (Section 3809(a) of the Internal Revenue Code of 1939) which Section read as follows:

§3809. Verification of returns; penalties of perjury.

"(a) Penalties. Any person who wilfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter, shall be guilty of a felony, and, upon conviction thereof, shall be fined not more than $2,000 or imprisoned not more than five years, or both."

Section 7206(1) Internal Revenue Code, 1954 superseded Section 3809(a), Internal Revenue Code, 1939. The description of the offense is the same, but the penalty was changed.

Enactment of Section 3809 was accompanied by express repeal of certain other laws including Section 145(c) of Title 26, United States Code (Section 145(c) of the Internal Revenue Code of 1939) which provided as follows:

§145. Penalties

* * * * *

"(c) Any individual who willfully makes and subscribes a return which he does not believe to be true and correct as to every material matter, shall be guilty of a felony, and, upon conviction thereof, shall be subject to the penalties prescribed for perjury in section 125 of the Criminal Code."

from a filing and the offense of attempted evasion by means of such filing. *Taylor* v. *United States,* 179 F.2d 640 (9th Cir., 1950), cert. den., 339 U.S. 988.

The government was entitled to proceed against the appellant under several sections of the Internal Revenue Code. It could and did charge him with attempt to evade his income tax in violation of Title 26 U.S.C., Section 7201. It could also, and it did, charge him with a violation of the section relating to false statements, Title 26 U.S.C., Section 7206(1). The choice lies with the government and it is not the privilege of the appellant to say how and under what section or sections the government should proceed. "Congress may make each separate step in a prohibited transaction a separate offense." *Taylor* v. *United States, supra; Catrino* v. *United States,* 176 F.2d 884 (9th Cir., 1949). In *Albrecht* v. *United States,* 273 U.S. 1, 11, (1927), the Supreme Court said:

> "There is nothing in the Constitution which prevents Congress from punishing separately each step leading to the consummation of a transaction which it has power to prohibit and punishing also the completed transaction."

The Supreme Court has held that in tax matters acts which overlap to some extent can be prosecuted or punished separately. See *United States* v. *Noveck,* 273 U.S. 202, 206 (1927); *United States* v. *Beacon Brass,* 344 U.S. 43 (1952).

Appellant contends (O. B. 33) that Section 7201 charges the same offense as set forth in Section 7206(1), and that the proof of the offense is, likewise, the same. This, of course, is not the case.

The purpose of Section 7206(1) is to impose the penalties for perjury upon those who wilfully falsify their returns *regardless of the tax consequences* of the falsehood. On the other hand, Section 7201 condemns wilful attempts to evade or defeat taxes "in any manner," and one manner is by the wilful filing of a return known to be false in some material respect. While proof of an offense under Section 7201 may also prove an offense under Section 7206(1), it must in addition indicate an intent in some manner to evade or defeat a tax which is due.

Appellant's argument (O. B. 33-35) that it was error for the Court to fail to require the government to elect as between the first three counts of the indictment and the last three counts rests upon the fallacious assumption that an indictment charging violations of Sections 7201 and 7206(1) defines crimes the elements of which are identical. The scope of the two sections is different.

The offense charged in the latter three counts is an incidental step in consummation of the completed offense of an attempted evasion of tax by means of a false and fraudulent return charged in the first three counts of the indictment. See *Gaunt* v. *United States,* 184 F. 2d 284, (1st Cir., 1950), *cert. den.,* 340 U.S. 917.[7]

Appellant alleges (O. B. 32) the indictment was insufficient on Counts 4, 5 and 6 because materiality was not charged; and that the trial court should have required the government to state how the false statements in Counts 4, 5 and 6 were material (O. B. 35).

Where it is required, materiality must be alleged in the indictment or sufficient facts must be alleged in the

[7]In *Gaunt*, Section 145(c), the forerunner of 7206(1), was under consideration. See footnote 6, *supra.*

indictment from which materiality may be inferred. Both these tests were met in the indictment in this case. Counts 4, 5 and 6 are substantially in the words of 7206(1) and are sufficient. See *United States* v. *Accardo,* 298 F. 2d 133 (7th Cir., 1962), reversed on other grounds.

Since the Government chose to proceed under Section 7206(1), the question of materiality of statements in appellant's tax returns should be decided by reference to Section 7206(1) and not by an interpretation of what is material under some other section. A statement in an income tax return concerning the amount of income is obviously material to the contents of that return. When the appellant failed to report all of his income on his returns, the statements in each of said returns with respect to his income were false with respect to a matter material to those returns, and material insofar as the governmental agency with which the returns were filed was intimately concerned.

The Internal Revenue Service must have a complete and truthful disclosure to audit a return. The United States and its agency, the Internal Revenue Service, was entitled to have on the date the return was filed the correct amount of appellant's income. The question with respect to materiality is whether or not appellant's statements were calculated to induce action or reliance by an agency of the United States Government. See *Brandow* v. *United States,* 268 F. 2d 559 (9th Cir., 1959). Materiality in matters of this kind lies in the

> ". . . intent to protect the authorized functions of governmental departments and agencies from the

> perversion which might result from the deceptive practices described."

United States v. Gilliland, 312 U.S. 86, 93 (1941).

Appellant argues that in a Section 7206(1) prosecution the government must prove, among other things, that a tax was due and owing. He relies on *Poonian* v. *United States,* 294 F. 2d 74 (9th Cir., 1961), to support this allegation, but that case does not hold that a Section 7206(1) conviction regarding an income tax return cannot be had without a showing of a tax due and owing. Appellant's contention here that *Poonian* stands for the proposition that a tax due and owing must be found to sustain a Title 18 U.S.C., Section 1001 (the statute being considered in that case) false statement conviction, and, therefore, by parity of reasoning, a 7206(1) conviction is, at best, a strained interpretation of dicta appearing in the *Poonian* opinion. The language presumably relied on by appellant in the *Poonian* opinion is as follows (p. 76):

> "This Court refuses to construe the statute in question [1001] so as to permit a taxpayer to be convicted for reporting more taxes than he rightfully owes, regardless of what his intentions may have been."

This language was not necessary to the decision in *Poonian,* which case reversed a conviction under Section 1001 because there was a fatal variance between the government's proof and the charging language of the indictment.

The further answer to appellant's arguments (O. B. 42-48) on requirements of proof of "tax due and owing" insofar as it relates to Section 7206(1) is governed by

what was heretofore said with respect to appellant's contentions regarding election between counts. *Supra,* p. 39-41.

Section 7206(1) makes it a felony merely to make and subscribe a tax return without believing it to be true and correct as to every material matter whether or not there was a tax liability due.

What has been said with respect to appellant's contention that a tax due and owing must be proved to sustain a charge under 7206(1) is dispositive of his analogous contention that in order to find wilfulness under Counts 4, 5 and 6 of the indictment appellant must have had a tax evasion intent (O. B. 51-55). The standard of wilfulness under these three counts is as described by the trial judge (App. xxviii). The wilful element is the deliberate and knowledgeable making and subscribing of a false statement in a tax return such to be determined from the evidence. That element does not require a finding that the purpose in so doing was to evade or defeat tax.

Appellant also contends (O. B. 48-51) that he was entitled to have given his proposed instructions 29, 30 and 35. As we read these proposed instructions, appellant would require that before the jury could find that there was unreported income it must first take into account any alleged additional deductions from gross income (such as an operating loss). This argument is merely another side to appellant's contention that there must be a tax due and owing. Section 7206(1) proscribes the making of a statement which the taxpayer "does not believe to be true and correct as to every material matter." It is a false statement statute. Appel-

lant was charged with subscribing to tax returns which he knew did not disclose certain items of income, namely, legal fees, commissions, partnership receipts, interest and dividends. It was the falsity of the return by not disclosing these items of income which is the gist of the charge. *United States* v. *Rayor,* 204 F. Supp. 486 S.D. Cal. 1962). Accordingly, whether appellant had offsetting losses against the unreported income is irrelevant to the charge. The question of offsetting deductions would be necessary for the jury to consider only if the issues were whether there was a tax due and owing, which as we have said above is not a consideration in a Section 7206(1) prosecution.

VI. The Court's Instructions on Wilfulness and Intent Did Not Constitute Reversible Error.

The appellant contends that the Court's instructions on wilfulness[8] constitute reversible error (O. B. 36-39). He further claims (O. B. 39-41) that another portion of the Court's charge bearing on the question of intent was erroneous. Questions presented by these two separate assignments of error will be treated together.

Specifically, two paragraphs of the Court's charge on "wilfulness" are challenged (O. B. 36-37). They are as follows:

> "You are instructed that in common, everyday speech 'wilful' denotes an act which is intentional, knowing or voluntary, as distinguished from accidental; but when it is used in a criminal statute, where one of the elements is a specific intent to

[8]This does not include appellant's separate contention that with respect to Counts 4, 5 and 6 the Court's instruction on wilfulness was error.

> defraud, it has a somewhat different meaning. It generally means an act done with a bad purpose, without justifiable excuse. The word wilful is also used to characterize a thing done without ground for believing it is lawful." (App. xviii.)
>
> "If a taxpayer honestly believes that he has paid all the taxes he owes, he is not guilty of criminal evasion. But if he acts without reasonable ground for belief that his conduct was lawful, it is for you to decide whether he was acting in good faith or whether he intended to evade the tax." (App. xxiii-xxiv.)

The first of these two paragraphs was requested by appellant himself (Tr. 1032, 1057) and represents, word for word, the first paragraph of his requested instruction No. 19 (App. xxxviii).

Appellant says the above is the so-called "Murdock" instruction and that this instruction has been disapproved by this Court on many occasions (O. B. 37). *United States* v. *Murdock,* 290 U.S. 389 (1933). In *Murdock,* the Supreme Court had before it the question of whether a wilful refusal to supply information meant a voluntary intentional refusal as the trial court had charged, or whether it meant something more. In holding that in a criminal statute it did mean something more than knowing or non-accidental, the Court set forth five definitions of wilful. The trial court here, in the last sentence of the second paragraph set forth above, used but one of the several definitions supplied by the Supreme Court in *Murdock.*

Although appellant did not request the second paragraph of the instruction above set forth, language contained therein:

> "* * * But if he acts without reasonable ground for belief that his conduct was lawful * * *"

is the same in substance, and merely a restatement of the last sentence of the appellant's requested instruction. Consideration, then, of appellant's requested instruction would suffice to respond to his argument on this point.[9]

Apart from the fact that the instruction on wilfulness was requested by the appellant himself, the Supreme Court found no error in an instruction similar to the one here involved, but which, in fact, used more of the so-called *Murdock* definitions of wilful.[10]

Appellant claims that in *Bloch* v. *United States,* 221, F. 2d 786 (9th Cir., 1955) this Court disapproved the instruction given here. On many separate occasions the jury was told in the Court's comprehensive charge on intent and wilfulness that the intent requisite to conviction entailed an intentional evasion of outstanding tax liability (App. xvi, xvii, xxiv, xxv, xxvi). That was not done in *Bloch.* In the case at bar the jury was not told separately that under the offense charged, wilfully meant filing a false return with a "bad purpose or without justifiable excuse." Similarly they were not told separately that if the defendant acts "without reasonable grounds for belief that his conduct was lawful" he

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[9]Those portions of the instruction not requested by appellant and which do not restate the portion of his requested instruction are beneficial to appellant and could not be considered erroneous.

[10]In *Friedberg* v. *United States,* 348 U.S. 142, (1954) affirming an income tax evasion conviction under Section 145(b) of the Internal Revenue Code of 1939, the predecessor to Section 7201, the Supreme Court found no error at all in the trial Court's instructions which had been approved by the Court of Appeals. *Friedberg* v. *United States,* 207 F.2d 777, (6th Cir., 1953). The trial court's pertinent instructions on wilfulness in *Friedberg* were (Record p. 648):

> "In this connection the Court instructs you that the word 'willful' means not only intentional or knowing, but 'done with a bad purpose . . . without justifiable excuse . . . stubbornly, obstinately, and perversely.'"

intended to evade the tax. The description of mental state which the trial court gave in its instructions to the jury came within the framework of instructions which taken as a complete unit told the jury that, to be found guilty, appellant must have wilfully intended to evade his true tax liability. The instruction in question should not be isolated from the charge as a whole. *Bateman* v. *United States,* 212 F. 2d 61 (9th Cir., 1954).

In isolating the two paragraphs from the general context of the charge on wilfulness in the instructions as a whole, appellant carries to unreasonable lengths his argument for reversal of this case on the ground of erroneous instructions on that issue.

This Court has on previous occasions found no error in this instruction given by the court and requested by appellant. In fact in other cases in this Circuit, a similar instruction which was found not to be erroneous was more detailed in the particular "*Murdock* language" complained about by the appellant. (O. B. 36-37.) In *Himmelfarb* v. *United States, supra,* and *O'Connor* v. *United States,* 175 F. 2d 477 (9th Cir., 1949), this Court approved an instruction similar to the one complained of here. There is only one case which seems to hold that the *Murdock* description of wilfulness under Section 7201 is error. *Forster* v. *United States,* 237 F. 2d 617 (9th Cir., 1956).

In *Forster v. United States, supra,* the so-called *Murdock* instruction, not given in the original charge to the jury, was given to the jury on its second day of deliberation when the jury returned to the courtroom and asked for further instruction on the subject of wilfulness. The Court stated at that time to the jury (p. 620):

"Now to supplement that, as I say again, I am going to give you, in substance the same matter.

"When used in a criminal statute—that is, the word 'wilfull' or 'wilfully'—when used in a criminal statute it generally means an act done with a bad purpose, without justifiable excuse, stubbornly, obstinately, perversive."

"The word is also characterized—employed to characterize a thing done without ground for believing it lawful, or conduct marked by reckless disregard whether or not one has the right so to act."

This Court in the *Forster* case at page 621 stated:

"Reluctantly this Court has concluded, principally on the authority of *Spies* v. *United States,* 317 U.S. 492, (1943) that the case must be reversed because of the second part of the instruction. It is a close decision. But the instruction with its variegated alternatives of wilfulness here occurred at too critical a time. In the posture it entered it came into too bright a light. It did not run a long chorus line. Here to let it stand would be to endorse the doubtful proposition that jurors disregard the instructions anyway."

Much of the condemned *Forster* instruction was asked for here by the appellant. Second, the context in which the *Forster* instruction was given differed materially from the context here.

It is novel indeed for appellant to urge this Court to entertain the notion that an instruction requested by him should be the grounds for reversing a conviction when he now decides that that which he requested was not

proper.[11] Apart from that, however, it is clear that in view of prior rulings by the Court and by the Supreme Court the instructions on wilfulness and intent were not error.

The appellant further contends (O. B. 39-41) that another paragraph of the trial court's instruction on intent was erroneous. In the course of its detailed charge the Court instructed the jury that to convict they must find that appellant acted with a specific intent to evade the tax. (App. xvi.) Appearing among those instructions was the following (App. xi):

> "It is reasonable to infer that a person ordinarily intends the natural and probable consequences of acts knowingly done or knowingly omitted, so unless the contrary appears from the evidence, the jury may draw the inference that the accused intended all the consequences which one standing in like circumstances and possessing like knowledge should reasonably have expected to result from any act knowingly done or knowingly omitted by the accused."

This sentence is assigned as reversible error affecting substantial rights because, appellant claims, the trial court told the jury in effect it could draw the conclusion that the appellant had intended to defeat or evade his taxes from the mere fact that he filed an incorrect income tax return. This argument has no merit. The appellant states (O. B. 40) that this Court has specifically

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[11]Rule 30 F.R. Crim. Proc.—Instructions.

". . . No party may assign as error any portion of the charge or omission therefrom unless he objects thereto before the jury retires to consider its verdict. . . ." Here we do not have a party failing to object to the court's own instruction or one offered by the other party; but rather, appellant now assigns as error his own requested instruction which was never withdrawn, which the Court announced twice would be given (Tr. 1032, 1057) and which was given.

disapproved the "natural and probable consequences of his acts" instruction in *Bloch* v. *United States, supra,* the only case relied on by appellant on this point. The instruction to which appellant refers in the *Bloch* case was in language dissimilar and substantially different from the language of the instruction by the trial judge in this case. The language found to be erroneous in the *Bloch* case was as follows (p. 788):

> "The presumption is that a person intends the natural consequences of his acts, and the natural inference would be if a person consciously, knowingly and intentionally did not set up his income and thereby the Government was cheated or defrauded of taxes, that he intended to defeat the tax."

In *Legatos* v. *United States,* 222 F. 2d 678 (9th Cir., 1955) and *Bateman* v. *United States, supra,* this Court had before it for consideration an instruction similar to that given in *Bloch,* and which, as in *Bloch,* was in language quite different from the instruction complained of here. In *Legatos,* decided after *Bloch,* this Court concluded that considered as a whole the Court's instructions on intent and wilfulness clearly and directly stated the law and were not such as to mislead the jury. The Court distinguished the *Legatos* case from the *Bloch* case, where, it was noted, the effect of the Court's instruction considered as a whole was not discussed.

In *Legatos, supra,* this Court said (p. 687):

> "* * * in *Bateman* v. *U.S.,* 212 F. 2d 61, 69, this Court came to the conclusion that an instruction in a tax evasion case that 'the law presumes that every man intends the natural and probable consequences

> of his own voluntary acts' was not prejudicially erroneous for the reason that, considered as a whole the trial court's instructions on intent, 'correctly stated the law, were plain and understandable, and left no room for doubt in the minds of the jurors.' "

It is submitted that here the same reasoning should apply. Whatever vitality *Bloch* had has been virtually extinguished by this Court's decision in *Legatos.*

Appellant refrains from any reference to the paragraphs of the Court's charge directly prior to and directly following the paragraph complained of (App. x-xi). Upon a reading of those three paragraphs together it is clear that in this portion of his charge the Court was instructing the jury on the proof of intent in general. It was later that the Court instructed on wilfulness insofar as it specifically related to the charge of tax evasion, Section 7201, and the first three counts of the indictment. (App. xvi-xviii, xxiv-xxvi.)

It is most unrealistic for appellant to "lift" the single paragraph from its immediate context of the preceding and following paragraphs and say that it alone is erroneous; and to isolate it from the full charge of the court on intent and wilfulness that was given later serves only to further compound the unsoundness of appellant's approach to this issue.

The word "infer" in the instruction given by the Court as distinguished from the word "presume" makes the two instructions, apart from any other consideration, manifestly different. As was stated by the Court of Appeals in *Grayson* v. *United States,* 107 F.2d 367 (8th Cir., 1939), holding a similar instruction not to be prejudicial, p. 370:

> "The use of the words 'presume' or 'presumption' in this connection is not to be approved. No doubt *inferences* as to intent may be gathered from subsequent acts and conduct, but no *presumption* of the law follows to invade and restrict the province of the jury." (Emphasis supplied.)

The question of the particular intent was not treated as a question of law here, but as a matter to be submitted to and resolved by the jury.

The instruction here at issue did not have the effect of giving to the jury a conclusive presumption on the question of intent which other evidence could not overcome, nor of injecting into the case an element of presumptive intent condemned in *Bloch*. The instruction in question did not operate to withdraw the question of intent from the jury or in any way inhibit their consideration of that issue.

Furthermore, in the *Bloch* instruction the court condemned *inter alia* the following language (p. 788):

> "* * * if a person did not set up his income. * * * and the Government was cheated or defrauded of taxes, that he intended to defeat the tax."

In the instruction being considered here there is no mention of "setting up income," or "cheating or defrauding the government." This instruction was merely part of the Court's general instruction. The difference in language of the two instructions, above, is sufficient to distinguish *Bloch* from this case.

In short, appellant claims that isolated portions of the trial court's instructions on wilfulness and intent, some of which he requested, constitute reversible error;

and in support of this contention relies on two of this Court's decisions. He disregards the fact that the language of the instructions complained of here is manifestly different than in these two cases; that the force of the *Bloch* case has been nullified by a later decision of this Court; that instructions cannot be isolated but must be read as a whole; and ignores the obviously peculiar context and circumstances in which the instructions held to be erroneous in the *Forster* case were given.

The Government respectfully submits that the trial court's charge on wilfulness and intent was not erroneous.

VII. There Is No Merit to Appellant's Contention That Additional Instructions Should Have Been Given to Set Forth Alternative Theories of the Defense.

Appellant presented only one theory to support his contention that no tax was due and owing for the prosecution years. His sole contention was that he had an operating loss in 1951 from the bankruptcy of the T. R. Bechtel Company and the Bechtel Lumber Company, and that he was entitled to carry this loss forward and that this would wipe out any tax due and owing for the prosecution years. Appellant's contention was that the Bechtel bankruptcy resulted in his stock in these corporations becoming worthless, and that this was a net operating loss from the operation of a business (not a capital loss). The basis of the net operating loss contention was that appellant claimed that he was engaged in the business of promoting corporations, and that when the Bechtel corporations failed he had an operating loss in his business of promoting corporations.

In support of his contention, appellant produced his

own accountant-expert on the witness stand to testify (in answer to an hypothetical question) that if the appellant was a promoter and dealer in corporations and had sustained the losses that appellant claimed he had sustained on the Bechtel bankruptcy in 1951, appellant would have an operating loss to carry forward in the prosecution years and there would be no tax due for any of these prosecution years. (Tr. 937-939.) The expert was not asked for his opinion as to what the tax would be under any other theory. The expert categorically told the Court that his opinion was predicated upon the assumption that the defendant was engaged as a promoter of corporations. (Tr. 964.)

Moreover, with respect to this issue, appellant's counsel cross-examined the government's expert-accountant only as to the effect on his computation if the appellant were a dealer in or promoter of corporations when he had his 1951 loss. (Tr. 488-499.) Appellant's other trial counsel said at the conclusion of the government's case and at the opening of the defense's case that it was their contention that a loss would be deductible because appellant was in the business (Tr. 535-536). Appellant's defense when he was on the stand was that he had filed a claim on his 1951 tax return that in connection with the Bechtel bankruptcy he had an operating loss as a promoter of corporations (Tr. 631) and that in 1954 he had been asked by the Internal Revenue Service to substantiate this claim on the 1951 return that he was in the business of promoting corporations (Tr. 630). Appellant testified extensively as to his activities with respect to the corporations purporting to show that he was primarily engaged in the business of promoting corporations (Tr. 637-638) but gave no testi-

mony to support any other theories of carry-forward operating losses. Appellant's counsel stated to the Court that his purpose was to establish two facts: "that the defendant was in the trade and business of dealing in corporations, and that all these corporations sustained losses which as a consequence he sustained as an operating loss" (Tr. 657). The record is clear that appellant's contention that he was entitled to an operating loss carry-forward was based solely on the claim that he was in the business of promoting corporations, and no other.

The Court fully instructed the jury on appellant's operating loss carry-forward contention based on appellant's claim that he was a dealer and promoter of corporations. (App. xix-xxiii.)

There was no probative evidence to warrant appellant's proposed instruction 26 (O. B. 56) that when a corporation was a mere dummy created solely as a protection against creditors or without any function other than as a receptacle for title the loss is a [carry-forward operating] loss of the taxpayer [rather than a capital loss]. Thus, appellant testified that the T. R. Bechtel Corporation was engaged in building houses in subdivisions (Tr. 634); one of the additional corporations formed, the Bechtel Lumber Company, had a lumber mill to supply lumber for the subdivisions (Tr. 638-639); twenty-three affiliated corporations were formed which were associated in the same general enterprise (Tr. 634); the affiliated corporations were set up to carry out the building of particular subdivisions (Tr. 662-663). The reasons for forming these subsidiary or affiliated corporations were to obtain the lower tax

rates where there are multiple corporations and also so that if any difficulties in financing one tract of houses placed with one subsidiary corporation were experienced, this would not impede the development of another tract being developed by another subsidiary corporation (Tr. 696-697, 702-704). It is plain therefore that the Bechtel family of corporations were performing the functions for which they were organized. There was thus no basis in the record for the proposed instruction.

Furthermore, there is no basis for appellant's contention (O. B. 58-59) that he was entitled to an instruction that the jury could have found a carry-forward operating loss on the Plaza Building on the grounds that appellant had suffered a loss because this partnership asset had been assigned to Tarman in an opinion of the Santa Rosa court. The evidence was clear that the ownership of the Plaza Building was still in dispute and that the litigation had not been concluded. The accountant for the Tarman-Sherwin partnership said so; appellant's counsel had said so (Tr. 339, 563); Revenue Agent Neilands said so (Tr. 563); appellant's expert at the trial who also had been engaged to do appellant's accounting at the Santa Rosa trial with respect to the Tarman-Sherwin partnership (Tr. 943) said so (Tr. 946). Appellant himself specifically stated that the Santa Rosa suit was still pending; that there had been a tentative opinion (Ex. I) of that court finding that the Plaza Building was the property of Tarman, but that the court had indicated that it would not make further findings until it had resolved further issues and had held further hearings and accordingly no formal judgment had been signed (Tr. 621-622).

Appellant testified that as a consequence of the Court's order, the Plaza Building remained in a status quo, namely in the possession of the Tarmans, subject to any future orders (Tr. 630). Appellant further testified that he at all times claimed a half interest in the Plaza Building (Tr. 854-855). He stated that the building grossed income of some $70,000 per year and had a net income of some $30,000, and if it were finally decided that this was still a partnership asset he would have to file amended returns in order to declare this income. (Tr. 665-666, 672, 682-683, 855; see also Tr. 340.) Thus, until there is a final disposition of the Plaza Building, appellant clearly could not claim he had an alleged loss on it. Indeed, if contrarily, it were adjudicated that appellant still has a half-interest in the Plaza Building, it would appear that he had underreported his partnership income by some additional $15,000 for each of the prosecution years. Accordingly, there is no evidence in the record which would warrant the Court in instructing the jury that appellant had suffered a loss on the Plaza Building.

In sum, we submit that the Court was not warranted in giving additional instructions on other theories which appellant had not relied on at trial and about which there was no probative evidence introduced at the trial.

VIII. There Is No Substance to Appellant's Contention That the Court Should Have Held That No Tax Was Due and Owing as a Matter of Law.

Appellant contends (O. B. 62-64) that there had been an administrative determination by the Internal Revenue Service that appellant had an operating loss in the years 1954, 1955 and 1956 resulting from his stock loss

in the 1951 bankruptcy of the Bechtel Corporations.[12] This contention is not only contrary to the law governing such matters, *United States* v. *Hardy,* 299 F. 2d 600, 605-606 (4th Cir., 1962), it is also contrary to the evidence here.

As we have shown *supra,* p. 14, the Internal Revenue Service had allowed appellant a 1950 carry-back operating loss resulting from a $21,115 *loan* he had made to the bankrupt Bechtel Corporation; this claim was allowed on what was called a tentative adjustment or a "quickie claim." Such a claim is allowed merely on the taxpayer's statement without examining the return or without additional investigation. (Tr. 1009.) With respect to the loss on appellant's *stock* in the bankruptcy of the Bechtel Corporations, appellant claimed in his correspondence with the Internal Revenue Service (Ex. 75) and on his 1951 and 1952 returns merely that he had a *capital loss,* which is limited to $1,000 yearly against ordinary income.

It is difficult to understand how the trial court and jury in this trial would be bound, as appellant claims (O. B. 59-65), with respect to the determination of the additional tax liability of appellant for the years 1954, 1955, and 1956, by a "quickie claim" allowed with respect to appellant's 1950 return. There was no final agreement as to the correctness or incorrectness of such an allowance. (Tr. 1011, 1015-1016.) Even if the gov-

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[12]Appellant's statement that the government's technical expert conceded that, on this examination of claims, the Internal Revenue Service "came to the conclusion that the defendant was a dealer in corporations," (citing Tr. 498) is not correct. Appellant has merely quoted the question asked of the expert by appellant's counsel but has failed to give the expert's reply, which was that he "would say that someone within the Service is requesting additional information to make a determination whether or not the defendant was in the business." The government's expert further answered (Tr. 499): "No, sir. I don't think I could say that I found any documents which would satisfy me that he was a dealer in corporations."

ernment were now precluded from assessing a deficiency concerning this "erroneous refund" (Tr. 430) on the 1950 return with respect to a loss claimed on account of a *loan,* the government was certainly not bound with respect to other tax years, *a fortiori* when it concerns a different kind of claim—i.e., a *stock* loss.

We submit that there was patently no grounds for the Court holding that as a matter of law there was no tax due and owing by appellant for the prosecution years. Since this contention constituted appellant's defense at the trial, the issue was properly submitted to the jury. By its verdict the issue was resolved against appellant. There was no error in the Court's handling of the issue.

CONCLUSION

Appellant had a fair and proper trial. The record supports the verdict. The instructions were correct. It is respectfully submitted that the judgment should be affirmed.

Dated, San Francisco, California,

March 1, 1963.

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Attorneys for Appellee.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

DAVID R. URDAN
Assistant United States Attorney

LAWRENCE K. BAILEY
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Appendix

Appendix

Court's Instructions to the Jury (Tr. 1088-1132)

THE COURT:

Ladies and Gentlemen of the Jury:

We all agree that the jury has listened with commendable attention to the taking of the evidence in the case and to the arguments of counsel. We have now reached the stage of the trial of this case where the Judge of the Court has the duty of instructing you as to the principles of law which are applicable to the case, and I invite from you the same attention that you have given to the witnesses and to the counsel.

You ladies and gentlemen are obligated under your oaths as jurors to decide this case only upon the evidence which is before you. The evidence has been concluded. It consists of oral testimony given under oath by the witnesses who have appeared before you, the documentary evidence which has been received in evidence, and the stipulations as to facts which have been entered into in writing or orally by counsel during the trial of the case.

The proof which has been developed, the facts which are to be found, and the conclusions thereon, are entirely and solely within the province of you twelve members of the jury. I have nothing to do with the facts of the case.

Although you as jurors are the sole judges of the facts, you are duty-bound to follow the law as stated in the instructions of the Court and to apply the law so given to the facts as you find them from the evidence before you. I must not trespass, and I do not trespass upon your duty, the duty of determining the facts and the

credibility of the witnesses, and I expect that you will not trespass upon my duty, namely, to give you the applicable law.

You are not to single out one instruction alone as stating the law, but must consider the instructions as a whole.

Neither are you to be concerned with the wisdom of any rule of law. Regardless of any opinion you may have as to what the law ought to be, it would be a violation of your sworn duty to base a verdict upon any other view of the law than that given in the instructions of the Court.

In the course of my instructions I will give you some general rules applicable in all criminal cases to aid you in determining the weight of the evidence in the case and the manner in which you should adjudge the evidence.

These will be followed by specific instructions applicable to Counts One, Two and Three alone, and other specific instructions applicable to Counts Four, Five and Six alone. I will then conclude with such further general instructions as should be given to you before you retire to deliberate. Unless specifically limited to particular counts, all instructions given to you shall be deemed to apply to each count of the indictment.

You have been chosen and sworn as jurors in this case to try the issues of fact presented by the allegations of the indictment and the denials made by the "not guilty" plea of the accused. You are to perform this duty without bias or prejudice as to any party. The law does not permit jurors to be governed by sympathy, prejudice, or public opinion. The accused and the public expect that you will carefully and impartially consider all the evi-

dence, follow the law as stated by the Court, and reach a just verdict regardless of the consequences.

The law presumes a defendant to be innocent of crime. Thus, a defendant, although accused, begins the trial with a clean slate, with no evidence against him. And the law permits nothing but legal evidence presented before the jury to be considered in support of any charge against the accused. So the presumption of innocence alone is sufficient to acquit a defendant, unless the jurors are satisfied beyond a reasonable doubt of the defendant's guilt from all the evidence in the case.

A reasonable doubt is a fair doubt based upon reason and common sense and arising from the state of the evidence. It is rarely possible to prove anything to an absolute certainty. Proof beyond a reasonable doubt is established if the evidence is such as you would be willing to rely and act upon in the most important of your own affairs. A defendant is not to be convicted on mere suspicion or conjecture.

A reasonable doubt may arise not only from the evidence produced but also from a lack of evidence. Since the burden is upon the prosecution to prove the accused guilty beyond a reasonable doubt of every essential element of the crime charged, a defendant has the right to rely upon failure of the prosecution to establish such proof. A defendant may also rely upon evidence brought out on cross-examination of witnesses for the prosecution. The law does not impose upon a defendant the duty of producing any evidence.

A reasonable doubt exists in any case when, after careful and impartial consideration of all the evidence, the jurors do not feel convinced to a moral certainty that a defendant is guilty of the charge.

If, after considering all the evidence in the case, you should find that any one of the material facts relied upon by the prosecution to establish the guilt of the defendant as to any particular count has not been established to a moral certainty and beyond a reasonable doubt, then you must return a verdict finding the defendant not guilty as to such count or counts of the indictment, even though you should also find that other facts in the case have been established.

As I stated to you during the empanelment of the jury, an indictment is but a formal method of accusing a defendant of a crime. It is not evidence of any kind against the accused, and does not create any presumption or permit any inference of guilt.

There are two types of evidence from which a jury may properly find a defendant guilty of an offense. One is direct evidence, such as the testimony of an eye witness. The other is circumstantial evidence, the proof of a chain of circumstances pointing to the commission of the offense.

As a general rule, the law makes no distinction between direct and circumstantial evidence, but simply requires that, before convicting a defendant, the jury be satisfied of a defendant's guilt beyond a reasonable doubt from all the evidence in the case.

If the evidence in this case as to any particular count is susceptible of two constructions or interpretations, each of which appears to you to be reasonable, and one of which points to the guilt of the defendant and the other to his innocence, it is your duty under the law to adopt that interpretation which will admit of the defendant's innocence and reject that which points to his guilt.

You will notice that this rule applies only when both of the two possible opposing conclusions appear to you to be reasonable. If, on the other hand, one of the possible conclusions should appear to you to be reasonable and the other to be unreasonable, it would be your duty to adhere to the reasonable deduction and to reject the unreasonable; bearing in mind, however, that even if the reasonable deduction points to defendant's guilt, the entire proof must carry the convincing force required by law and as stated in the instructions to support a verdict of guilty.

When the case which has been made out against a defendant rests entirely or chiefly on circumstantial evidence, before you may find a defendant guilty, basing your findings solely on such evidence, each fact which is essential to complete a chain of circumstances that will establish the defendant's guilt must be proved beyond a reasonable doubt.

It is not incumbent upon the defendant to prove his innocence, nor is it incumbent upon him to explain suspicious circumstances. He has the right to stand mute and demand that the Government make the case against him beyond a reasonable doubt.

Statements and arguments of counsel are not evidence in the case, unless made as an admission or stipulation of fact. When the attorneys on both sides stipulate or agree as to the existence of a fact, the jury must accept the stipulation as evidence and regard that fact as conclusively proved.

The Court may take judicial notice of facts or events which are matters of common knowledge. When the Court declares it will take judicial notice of some fact or event, the jury must accept the Court's declaration as

evidence and regard as conclusively proved the fact or event which the Court has judicially noticed.

The evidence in the case consists of the sworn testimony of the witnesses, all exhibits which have been received in evidence, all facts which have been admitted or stipulated, all facts and events which have been judicially noticed, and all applicable presumptions stated in these instructions. Any evidence as to which an objection was sustained by the Court, and any evidence ordered stricken by the Court, must be entirely disregarded.

You are to consider only the evidence in the case. But in your consideration of the evidence you are not limited to the bald statements of the witnesses. On the contrary, you are permitted to draw, from facts which you find have been proved, such reasonable inferences as seem justified in the light of your own experience.

An inference is a deduction or conclusion which common sense and reason lead the jury to draw from facts which have been proved.

A presumption is a conclusion which the law requires the jury to make from particular facts, in the absence of convincing evidence to the contrary. A presumption continues in effect until overcome or outweighed by evidence to the contrary; but unless so outweighed, the jury are bound to find in accordance with the presumption.

Unless and until outweighed by evidence to the contrary, the law presumes that a person is innocent of crime or wrong-doing; that a witness speaks the truth; that official duty has been regularly performed; that private transactions have been fair and regular; that the ordinary course of business has been followed; that things have happened according to the ordinary course

of nature and the ordinary habits of life, and that the law has been obeyed.

All evidence relating to any oral admission or other incriminating statement claimed to have been made by a defendant outside of court should be considered with caution and weighed with great care.

The rules of evidence ordinarily do not permit a witness to testify as to his opinions or conclusions. A so-called expert witness is an exception to this rule. A witness who, by education and experience, has become expert in any art, science, profession or calling, may be permitted to state his opinion as to a matter in which he is versed and which is material to the case, and may also state the reasons for such opinion. You should consider each expert opinion received in evidence in this case and give it such weight as you think it deserves, and you may reject it entirely if you conclude the reasons given in support of the opinion are unsound.

Government's Exhibits 67, 68 and 69, introduced through the witness Forest P. Calkins, and Defendant's Exhibit L, introduced through the witness Edward F. Moran, are summaries and an analysis of the primary evidence only, and are not primary evidence within themselves. Both parties were afforded full opportunity to examine and cross-examine the witnesses with respect to these exhibits and the method of making the same. These exhibits and the testimony of the witnesses relating thereto should be considered by you and are entitled to weight only to such extent as you, the jury, should find that the primary testimony of other witnesses and the exhibits upon which these summary and the analysis were based are entitled to weight and credibility.

These summaries and the analysis have no independent

value and were admitted only for your assistance and convenience in considering the other evidence which they purport to summarize.

If you choose to disregard as evidence all or a part of the testimony of any witness in this case, or do not accept the correctness of any document admitted in evidence, then you must likewise disregard so much of the said summaries or analysis as is based upon the testimony of such witnesses and such documents you decide so to disregard.

You, as jurors, are the sole judges of the credibility of the witnesses and the weight their testimony deserves. A witness is presumed to speak the truth. But this presumption may be outweighed by the manner in which the witness testifies, by the character of the testimony given, or by contradictory evidence. You should carefully scrutinize the testimony given, the circumstances under which each witness has testified, and every matter in evidence which tends to indicate whether the witness is worthy of belief. Consider each witness's intelligence, motive and state of mind, and demeanor and manner while on the stand. Consider also any relation each witness may bear to either side of the case; the manner in which each witness might be affected by the verdict; and the extent to which, if at all, each witness is either supported or contradicted by other evidence.

Inconsistencies or discrepancies in the testimony of a witness, or between the testimony of different witnesses, may or may not cause the jury to discredit such testimony. Two or more persons witnessing an incident or a transaction may see or hear it differently; and innocent misrecollection, like failure of recollection, is not an uncommon experience. In weighing the effect of a dis-

crepancy, consider whether it pertains to a matter of importance or an unimportant detail, and whether the discrepancy results from innocent error or wilful falsehood. If you find the presumption of truthfulness to be outweighed as to any witness, you will give the testimony of that witness such credibility, if any, as you may think it deserves.

Merely because a witness happens to be an official of the Government does not mean that such witness is entitled to any greater or special credit to his testimony. The testimony of any such witness should be weighed and scrutinized in the same manner as any other witness who has testified in this case.

All evidence of a witness whose self-interest or attitude is shown to be such as might tend to prompt testimony unfavorable to the accused, should be considered with caution and weighed with great care.

A witness may be discredited or impeached by contradictory evidence, or by evidence that at other times the witness has made statements which are inconsistent with the witness's present testimony.

If you believe that any witness has been impeached and thus discredited, it is your exclusive province to give the testimony of that witness such credibility, if any, as you may think it deserves.

If a witness is shown knowingly to have testified falsely concerning any material matter, you have a right to distrust such witness's testimony in other particulars, and you may reject all the testimony of that witness or give it such credibility as you may think it deserves.

If you should find from the evidence that there was a failure on the part of the defendant to supply any information for the purposes of the computation, assess-

ment or collection of his income tax, and if you find that such failure to supply such information was deliberate and with intent to conceal income subject to tax, this is a circumstance which may be considered in your determination of his guilt or innocence. Such failure to supply information, however, refers only to his conduct during the course of the investigation.

In every crime there must exist a union or joint operation of act and intent.

The burden is always upon the prosecution to prove both act and intent beyond a reasonable doubt.

With respect to certain lesser offenses, if it be shown that a person has knowingly committed an act denounced by law as a crime, intent may be presumed from the voluntary doing of the forbidden act. But with respect to crimes such as charged in this case, specific intent must be proved before there can be a conviction.

Specific intent, as the term itself suggests, requires more than a mere general intent to engage in certain conduct.

A person who knowingly does an act which the law forbids, or knowingly fails to do an act which the law requires, intending with bad purpose, either to disobey or to disregard the law, may be found to act with specific intent.

An act or failure to act is done knowingly if done voluntarily and purposely, and not because of mistake or inadvertence or other innocent reason.

Intent may be proved by circumstantial evidence. It rarely can be established by any other means. While witnesses may see and hear and thus be able to give direct evidence of what a defendant does or fails to do, there

can be no eye-witness account of the state of mind with which the acts were done or omitted. But what a defendant does or fails to do may indicate intent or lack of intent to commit the offense charged.

It is reasonable to infer that a person ordinarily intends the natural and probable consequences of acts knowingly done or knowingly omitted. So unless the contrary appears from the evidence, the jury may draw the inference that the accused intended all the consequences which one standing in like circumstances and possessing like knowledge should reasonably have expected to result from any act knowingly done or knowingly omitted by the accused.

In determining the issue as to intent, the jury are entitled to consider any statements made and acts done or omitted by the accused, and all facts and circumstances in evidence which may aid determination of state of mind.

If you find from the evidence that there was taxable income received and reported as the law requires, it makes no difference insofar as the question of liability for tax is concerned whether such income was lawfully received or unlawfully received, since the law makes no distinction between taxable income which is lawful and that which is unlawful in determining liability for income taxes.

An attorney or a judge of the Superior Court of the State of California may engage in a private business. There is nothing in either the law or the canons of professional or judicial ethics which forbids this kind of activity, if otherwise lawful. In this connection you are to make no inference unfavorable to the defendant in this case from the fact that during the practice of his

profession as an attorney or during his term of judicial office he engaged in private business transactions.

In addition, I instruct you that when an individual takes office as a judge, who was previously engaged in a private law practice, there is nothing improper in his receiving compensation for legal work which was performed by him prior to his taking judicial office.

I further instruct you that should you find that the defendant received fees for legal services rendered after he took judicial office, he is not here on trial for such conduct, nor is he on trial for any other act or conduct not alleged in the indictment. Any fees received by the defendant after he took judicial office, should you be satisfied that such fees were in fact received, for the purposes of this trial, are to be treated the same and no different than any other income received by the defendant from any other source. The fees and other income received, and not the source thereof, are material to this case, to the degree that you find such fees and other income go to make up the income of the defendant which was subject to tax during the years in question.

A portion of the income the Government is attempting to prove as unreported income is alleged by the Government to have been distributed to him in the form of property or things of value other than money. The fair market value of such property or thing is the amount to be included as income. The burden is upon the Government to prove that such property so distributed has a market value in the amount claimed by the Government, or such value as would constitute the same substantial income.

If the services in exchange for which the property or things of value were received were rendered at a stipu-

lated price, in the absence of evidence to the contrary such price shall be presumed to be the fair market value of the compensation received.

Evidence to the contrary, and from which fair market value may be fixed, may be one or more of the following:

1. The price at which a willing buyer and a willing seller would arrive after negotiations, where neither is acting under compulsion.
2. The price at which such property has been sold at or about the time of distribution to the taxpayer. However, such sale must be an actual sale rather than a security transaction.
3. The book value, if any, of the property.
4. Any expression of opinion by persons who were in a position to know the value of the property, including the defendant.
5. And whether or not the property was productive of income or capable of producing income in the future, such capacity to produce income being tested by the expectations thereof at the time of distribution and not necessarily by the subsequent history of the property.

A taxpayer partner is taxable upon his distributive share of the partnership profits in the years his proportionate share was earned, even though subsequent disagreement with his partner and litigation precluded him from ever receiving any of his money.

The fact that each partner's distributive share in the net income of the common venture may not be currently distributed due to a dispute, or as the result of operation of state law, or until the contractual obligations of the

joint venture are fully performed, renegotiated, and its debts paid in accordance with the terms of the agreement of the parties, does not relieve them from reporting as income their proportionate shares of the net profit in the year it is earned.

This is true even though the taxpayer partner is on the cash basis of accounting and did not actually receive the income.

You may consider the defendant's failure to report income from the Tarman-Sherwin partnership in 1954, 1955 and 1956, if from the evidence you are satisfied beyond a reasonable doubt that he failed to report such income, on the question of his wilful intent to evade tax and on the question of whether when he made and subscribed his tax returns for those years he believed them correct as to every material matter.

For income tax purposes, a joint venture and a partnership are the same, and income from a joint venture is required to be reported in the same manner as income from a partnership.

There is a distinction between the civil liability of a defendant and the criminal liability. This is a criminal case. The defendant is here charged with the commission of a crime, and the fact that he may have or may not have settled the civil liability for the payment of taxes claimed to be due to the United States is not to be considered by you in determining the issues in this case, except as it may throw some light on the intent of the defendant.

The first three counts of the indictment cover the calendar years 1954, 1955 and 1956. Except for the amount of taxable income and the amount of tax due and owing for each of such years, Counts One, Two and

Three are identical in all other respects. Hence, I shall now read to you only the first count: The first count of the indictment alleges a violation of Section 7201, Title 26, United States Code:

> "The Grand Jury charges that on or about July 15, 1955, in the Northern District of California, Southern Division, Marvin Sherwin, defendant herein, who during the calendar year 1954 was married, did wilfully and knowingly attempt to evade and defeat a large part of the income tax due and owing by him and his wife to the United States of America for the calendar year 1954, by filing and causing to be filed with the District Director of Internal Revenue at San Francisco, California, a false and fraudulent joint income tax return on behalf of himself and his wife, wherein it was stated that their taxable income for the calendar year 1954 was $21,211.01, and that the amount of tax due and owing thereon was $5,743.60; whereas, as he then and there well knew, their taxable income for the calendar year 1954 was $33,993.64, upon which taxable income there was due and owing to the United States of America an income tax of $11,396.82."

Counts One, Two and Three of the indictment charge the defendant, as I stated, with a violation of 26, United States Code, Section 7201, which in pertinent part reads as follows:

> "Any person who wilfully attempts in any manner to evade or defeat any tax imposed by the Internal Revenue Code or the payment thereof, shall be guilty of an offense against the laws of the United States."

Three essential elements are required to be proved in order to establish the offense charged in each of Counts One, Two and Three of the indictment:

> First: The fact that a substantial amount of federal income tax was in fact due and owing from the defendant for the calendar years in question, namely, 1954, 1955 and 1956, in addition to the tax declared or disclosed in the defendant's income tax returns for said calendar years;
>
> Second: Knowledge of the defendant that some additional income tax of a substantial amount was due and owing from him to the Government for such calendar years; and
>
> Third: The fact that the defendant in the manner charged in such counts of the indictment wilfully attempted to evade or defeat the additional tax, with the specific intent to defraud the Government of such additional tax.

Failure to prove any one of these three elements beyond a reasonable doubt will entitle the defendant to a verdict of not guilty on such of Counts One, Two and Three as to which such convincing proof is lacking.

It is not necessary that the evidence establish an evasion of all the tax alleged in the indictment. It is sufficient if the evidence establishes beyond a reasonable doubt that the defendant wilfully attempted to evade any substantial portion of the tax as charged.

Further as to Counts One, Two and Three, I charge you that the word "attempt," as used in the statute just read and in the indictment and these instructions, involves two things: (1) An intent to evade or defeat the tax, and (2), some act done in furtherance of such intent. Thus the word "attempt" contemplates that the

accused had knowledge and understanding that during the calendar years 1954, 1955 and 1956 he had an income which was taxable and which he was required by law to report, and that he nevertheless attempted to evade or defeat the tax thereon, or a substantial portion thereof, by purposely failing to report all the income which he knew he had during such calendar years and which he knew it was his duty to state in his returns for such years, or in some other manner.

Various schemes, subterfuges and devices may be resorted to in an attempt to evade or defeat a tax. The one alleged in the indictment is that of filing false and fraudulent returns with the intent to defeat the tax. The statute plainly makes it an offense wilfully to attempt to evade in any manner any income tax imposed by law.

The attempt to evade or defeat the tax must be a wilful attempt; that is to say, it must be an attempt knowingly made with the specific intent to keep from the Government a tax imposed by the income tax laws which it was the duty of the defendant to pay to the Government.

In other words, the attempt must be knowingly made with the bad purpose of seeking to defraud the Government of some substantial amount of income tax lawfully due from the defendant.

Section 7201 of the Internal Revenue Code, which I quoted to you and which applies to the first three counts, makes any person guilty of crime who "wilfully attempts in any manner to evade or defeat any income tax or the payment thereof."

The mere failure of a taxpayer to report a portion of his taxable income is not a crime within the meaning of this section unless it has been proved beyond a reason-

able doubt that he wilfully attempted to defeat or evade his income taxes.

You are instructed that in common, everyday speech "wilful" denotes an act which is intentional, knowing or voluntary, as distinguished from accidental; but when it is used in a criminal statute, where one of the elements is a specific intent to defraud, it has a somewhat different meaning. It generally means an act done with a bad purpose, without justifiable excuse. The word "wilful" is also used to characterize a thing done without ground for believing it is lawful.

You are instructed that the thing done is not necessarily and under all circumstances required to be lawful. It is sufficient to exculpate and exonerate a defendant if it is honestly believed to be lawful. Or to put it conversely, it is unlawful if it is done without grounds for believing in its lawfulness.

If an act is done in good faith, based upon an actual belief of a defendant, even if such belief is a mistaken one, or a negligent one, or if such defendant is in ignorance of either facts or law rendering it unlawful; and if you believe that the defendant, Marvin Sherwin, honestly made a mistake, honestly was negligent and honestly was either ignorant of the facts or ignorant of the law, you will then determine that his conduct in doing what he did was not wilful.

As I indicated to you, one of the essential elements to be established beyond a reasonable doubt as to the first three counts of the indictment is that a substantial amount of federal income tax was due and owing from the defendant for the particular years covered by these counts.

If you find that no such tax was due, or that the

defendant honestly believed no such tax was due for any of these years, you shall find the defendant not guilty on the count or counts covering such years for which you may so find.

If, on the other hand, you are satisfied beyond a reasonable doubt that a substantial tax (over and above that declared or disclosed in the returns) was due and owing from the defendant for any of such years, and that the defendant knew or believed the same to be due, and that with such knowledge and belief he filed a false and fraudulent income tax return for any such year in a wilful attempt to evade and defeat a large part of the tax due for such year, and with intent to defraud the Government of such additional tax, you shall find the defendant guilty on such count or counts of Counts One, Two and Three, covering the years for which you so find.

I shall now instruct you on the question of whether the losses sustained by the defendant by reason of the bankruptcy of T. R. Bechtel Company and Bechtel Lumber Company were net operating losses in a business of the defendant or a loss from the sale or exchange of capital assets.

This question applies directly to the first three counts and has no application to the last three counts, except to the degree that you may find such losses have a bearing on his intent or, to be more specific, his belief that his returns were true and correct as to every material matter.

This question as to the nature of these losses is a question of fact to be determined by you, the jurors, from the evidence in the case and in accordance with the applicable tests that I shall give to you.

The defendant claims that such bankruptcy resulted in the stocks of these corporations becoming worthless, and were therefore net operating losses arising from the operation of a business of the defendant.

The Government claims that these losses were not net operating losses arising from the operation of a business of the defendant, but were in fact losses from the sale or exchange of capital assets.

This becomes of importance to you in determining whether or not under the first three counts the prosecution has proven beyond a reasonable doubt that in fact there was a substantial amount of federal income tax due and owing from the defendant for any of the particular tax years in question, in addition to the tax declared or disclosed in the defendant's income tax returns for such years.

If you find that the losses of the defendant arising from the bankruptcy of the Bechtel corporations were in fact net operating losses from a business of the defendant, and that such losses which occurred in 1951 were greater than his taxable income for said year, such losses may be carried back to the year 1950, and any losses still remaining may be carried forward until extended through each of the years for which the defendant is under indictment on Counts One, Two and Three.

On the other hand, if you find that these particular losses arising from such bankruptcy were not net operating losses from a business of the defendant, you shall treat them as losses arising from the sale or exchange of capital assets, and such losses, for carry-over purposes to the years 1954, 1955 and 1956, shall be limited to $1,000 per year; and that amount was credited to him by the Government for each of such years.

The question of whether or not such losses were net operating losses from a business of the defendant or a loss from a sale or exchange of capital assets depends upon whether or not the defendant was actually engaged in a business separate and apart from his profession, in which losses were incurred in the operation of such business.

If under the test I give you, you find that the defendant was not engaged in a separate business, or if you find that such losses were not incurred in the operation of such separate business of the defendant, you shall treat such losses as losses from the sale or exchange of capital assets.

The business of the corporation may not be treated as the business of the stockholder. The mere fact that a person is a stockholder in corporations or active or interested in their affairs is not sufficient to say he is in the business of organizing and promoting corporations or to justify treating any advances to the corporation as business loans. A person must be extensively and regularly engaged in the business of promoting and financing business ventures to elevate that activity to the status of a separate business.

The defendant claims he was engaged in the separate business of promoting corporations. While any individual, including an attorney, may engage in any trade or business other than his particular profession, all the facts and circumstances must be examined to determine whether he is in fact engaged in such trade or business, in this instance, the promoting of corporations, or was merely rendering the services usually rendered by an attorney who incorporates businesses, makes substantial investments therein, and acts as attorney, director and

officer of such corporations in the conduct of the business and affairs of such corporations. If this is the limit and character of his financial investment, and the limit and character of the time, energy and interest he devotes to the business or affairs of such corporation, he cannot be deemed to be engaged in a separate trade or business.

More is required. To establish that he was engaged in the business of promoting corporations, the evidence must show that the defendant's investments, advances and activities were extensive, varied, frequent and regular, and with a profit motive arising from such activities on his part and not merely from future profits of the corporation distributable to him in proportion to his investment in such corporations.

A taxpayer's claim to a deduction from gross income is a statutory privilege; hence, the burden of going forward to prove such facts as will sustain the defendant's contention that these losses were net operating losses and therefore deductible in the manner he claims, rests with him.

If you find from the evidence that the defendant has established (or created a reasonable doubt in your minds as to whether or not he has established) that his investments in the Bechtel corporations and such other corporations in which he claims to have invested were substantial and varied and that his activities were so extensive, and with such frequency and regularity, as to consume a substantial portion of his time and energy, all for the purpose of making the business of the corporations succeed, then his investments and his activities were such that the losses sustained by him by reason of the bankruptcy of the Bechtel corporations constituted

net operating losses, deductible and subject to carry-back and carry-forward in the manner I have indicated.

If you find from the evidence and the test for the determination thereof given to you in these instructions that the defendant suffered net operating losses by reason of the bankruptcy of the Bechtel corporations, you shall fix the amount thereof as you will find it from the evidence.

The amount of the defendant's loss on the worthless stocks of the Bechtel corporations is limited to the excess of his cost basis in that stock over the amount realized (which in this case was zero because the stocks became worthless) rather than the excess of the fair market value over zero.

The agreement referred to in the testimony as that between Tarman and Sherwin of February 28, 1950, was a partial distribution of partnership interests and, as such, was not subject to tax.

The cost basis of the Bechtel Company stocks in the hands of the defendant when he received such stock pursuant to that agreement has been fixed from the evidence in this case in at least three different amounts: in the sum of about $58,000 by Agent Nielands, if the assumptions upon which his conclusions are based are correct; in the sum of $60,000 on the defendant's claim of capital loss on that stock in the tax returns of himself and his wife for the year 1951; and in the sum of $157,000 by Mr. Moran, if the assumptions upon which his conclusions are based are correct. What that loss in fact was, in the light of the evidence, is, as I previously stated, for you, the jury, to determine.

If a taxpayer honestly believes that he has paid all the taxes he owes, he is not guilty of criminal evasion.

But if he acts without reasonable ground for belief that his conduct was lawful, it is for you to decide whether he was acting in good faith or whether he intended to evade the tax.

The question of intent is a matter for you, as jurors, to determine. It is not possible to look into a man's mind to see what went on. For you to arrive at the intent of the defendant in this case, you must take into consideration all the facts and circumstances shown by the evidence, including the exhibits, and determining from all such facts and circumstances what the intent of the defendant was at the time in question. Wilfulness, of course, may be inferred from circumstances, and it is not necessary to prove wilfulness by direct evidence in an income tax evasion prosecution. Indeed, wilful intent in attempting to evade and defeat payment of tax may be supported by circumstantial evidence. Intent may be inferred from acts, and inferences may arise from a combination of acts, although each act standing by itself may seem unimportant.

Section 7201 of the Internal Revenue Code which, as I have stated, is applicable to the first three counts, punishes a wilful attempt to evade and defeat taxes in any manner. On this question of intent to evade income taxes there are a number of circumstances which you may consider in determining such intent. You may consider whether or not there was a concealment of assets, the covering up of sources of income, the number of income items omitted each year and their gross amounts, the handling of one's affairs to avoid the making of usual records, and any other such conduct, the likelihood of which would be to mislead or conceal are illustrations of the type of conduct or acts from which you may infer

intent to evade taxes if you are satisfied beyond a reasonable doubt from the evidence that such conduct existed in this case. If the tax evasion motive plays any part in such conduct, the offense may be made out even though the conduct I have mentioned might also serve some other purpose.

The question of intent is a question you must determine for yourself from a consideration of all the evidence.

If you find from the evidence that the defendant sought advice and counsel with respect to his income tax liability for the years 1954, 1955 and 1956 from an accountant, whom he thought would properly and correctly prepare his income tax returns, and if you further find that the defendant honestly attempted to provide such accountant and advisor with all the information reasonably necessary to enable such accountant to prepare correct income tax returns, and that the taxpayer, when he signed the same, presumed and believed that they were true and correct, then your verdict should be not guilty as to Counts One, Two and Three, for there would be absent the element of knowing and wilful intent to evade or attempt to evade the payment of income taxes; and your verdict should be not guilty as to Counts Four, Five and Six, for there then would have existed in the mind of the taxpayer an honest belief that the return was true and correct as to every material matter, even though it should later develop that said income tax returns were materially wrong.

As to any one of Counts One, Two and Three of the indictment, if you find from the evidence that the defendant in doing the acts detailed by the evidence introduced upon the trial herein, acted without corrupt

intent, that is to say, the intent to evade or defeat a large part of the income tax due and owing by him and his wife for the years in question, such lack of corrupt intent will entitle the defendant to an acquittal at your hands as to any such counts on which you so find.

Similarly, as to any one of Counts Four, Five and Six of the indictment, if you find from the evidence that the defendant, in subscribing to the joint tax return or returns for the years covered by the indictment, acted without corrupt intent in so subscribing, that is to say, with the belief that said joint return or returns were true and correct as to every material matter, such lack of corrupt intent will entitle the defendant to an acquittal at your hands as to any such counts on which you so find.

Counts Four, Five and Six of the indictment cover the calendar years 1954, 1955 and 1956. Except for the amount and source of the defendant's income, and the amount of additional income he is alleged to have failed to disclose for each of such years, said counts are identical in all other respects; hence, I will now read to you only the fourth count. It alleges that:

> "On or about July 15, 1955, in the Northern District of California, Southern Division, Marvin Sherwin, defendant, in violation of Title 26, United States Code, Section 7206, sub-paragraph 1, did wilfully and knowingly make and subscribe and file with the District Director of Internal Revenue at San Francisco, California, a joint income tax return for the calendar year 1954, in his name and in the name of his wife, Georgia Sherwin, which was verified by the defendant by a written declaration that it was made under the penalty of perjury,

which said joint income tax return for the calendar year 1954, the defendant did not believe to be true and correct as to every material matter in said joint income tax return for the calendar year 1954, in that the defendant stated that the income of himself and his wife for the calendar year 1954 was as follows:

"County of Alameda, $9,250.00; State of California, $7,500.00; Chip Steak Company, $5,520.00; other income, $2,505.56;

"Whereas, as he then and there well knew, he had additional income amounting to $12,801.45 which he failed to disclose in his and his wife's said joint return."

The federal statute to which these counts of the indictment refer, and with which the defendant is charged with violating, is Section 7206, sub-paragraph 1, Title 26, United States Code. Insofar as it is pertinent here to this case that statute reads as follows:

> "Any person who wilfully makes and subscribes any return, statement or other document which contains or is verified by a written declaration that it is made under the penalty of perjury, and which he does not believe to be true and correct as to every material matter, shall be punished as provided by law."

Now, for a violation of this statute to occur, three essential elements must be established beyond a reasonable doubt. They are:

1. A wilful making and subscribing of a return, statement or other document.
2. The return, statement or other document must contain a written declaration that it is made under the penalty of perjury.

3. The maker must not believe the return, statement or other document to be true and correct as to every material matter.

I instruct you as a matter of law that the federal income tax return, Form 1040, and their attached addenda and schedules, as made and subscribed by the defendant for the years 1954, 1955 and 1956, if you find such documents were made and subscribed by the defendant, are returns as contemplated by Section 7206 (1), Title 26, U. S. Code, which I just read to you.

In order to find the defendant guilty of any or all of the charges complained of in Counts Four, Five and Six of the indictment, you must not only believe that he did the acts complained of and of which he stands charged, but you must also believe that the acts were wilfully done by him.

The word "wilful," as used in this statute means deliberately and with knowledge, as distinguished from something which is merely careless, inadvertent or negligent.

Whether or not the act is done wilfully is a fact which must be determined by reasonable inference established from the facts proved by the evidence. Here, too, you cannot look into the defendant's mind to see what his intention was when he allegedly made the statements in question on his 1954, 1955 and 1956 federal income tax returns. If you find the defendant signed his income tax returns for these years, you may consider that as a circumstance in determining whether he had knowledge of the contents of those income tax returns. Wilfully means intentionally and not accidentally.

You are instructed that it is not necessary for the

Government to prove that there was a tax due and owing for any of the years in question in order to prove Counts Four, Five and Six of the indictment. The existence of a tax liability is not an element of the offense of wilfully subscribing to a tax return under the penalties of perjury when such tax return is not believed to be true and correct as to every material matter.

In order to find the defendant guilty of Counts Four, Five and Six of the indictment you must be satisfied beyond a reasonable doubt that the failure of defendant to report additional income received by him, if you so further find, was a material omission; in this connection, I instruct you that omission of a substantial part of the taxpayer's gross income from his tax return constitutes a material omission, and if you are satisfied beyond a reasonable doubt that there was such omission, and that it was wilful, and that the defendant had knowledge thereof, you shall find the defendant guilty as to such counts on which you so find.

The term "gross income" means all income from whatever source derived, including:

1. Compensation for services, fees, commissions, and similar items;
2. Gross income derived from business;
3. Gains derived from dealings in property;
4. Interest;
5. Dividends;
6. Distributive shares of partnership gross income.

In connection with Counts Four, Five and Six, if a person in good faith believes that his income tax return,

as prepared by him or as caused to be prepared by him, truthfully reports the taxable income and allowable deductions of the taxpayer, he cannot be guilty as to said counts.

Under Counts Four, Five and Six of the indictment, I instruct you that in order to convict the defendant you must find that any omission which was made in the defendant's return was wilfully omitted, and in this connection I instruct you that if the defendant did not believe that he had additional income which he was required to report when he made and subscribed his tax return, then you may not find the defendant guilty under these counts of the indictment.

Under Counts Four, Five and Six of the indictment the Government must prove that any fraudulent omission in the tax return of the defendant was for the purpose of defrauding or deceiving the United States of America in some material manner.

The law of the United States permits the judge to comment to the jury on the evidence in the case. Such comments are only expressions of the judge's opinion as to the facts, and the jury may disregard them entirely, since the jurors are the sole judges of the facts.

During the course of the trial I occasionally asked questions of a witness in order to bring out facts not then fully covered in the testimony. As I previously stated, do not assume that I hold any opinion on the matters to which my questions related. Remember at all times that you, as jurors, are at liberty to disregard all comments of the Court in arriving at your own findings as to the facts.

It is the duty of the Court to admonish an attorney who, out of zeal for his cause, does something which is

not in keeping with the rules of evidence or procedure. You are to draw no inference against the side to whom an admonition of the Court may have been addressed during the trial of this case.

And I might add here parenthetically that this case was well conducted by counsel for both sides, and conducted in accordance with the highest traditions of the American Bar.

It is the duty of attorneys on each side of a case to object when the other side offers testimony or other evidence which counsel believes is not properly admissible.

When the Court has sustained an objection to a question, the jury are to disregard the question and may draw no inference from the wording of it or speculate as to what the witness would have said if permitted to answer.

Upon allowing testimony or other evidence to be introduced over the objection of counsel, the Court does not, unless expressly stated, indicate any opinion as to the weight or effect of such evidence. As stated before, the jurors are the sole judges of the credibility of all witnesses and the weight and effect of all evidence.

As you have noted, a separate crime or offense is charged in each of the six counts of the indictment. Each offense and the evidence applicable thereto should be considered separately. The fact that you may find the accused guilty or not guilty of one of the offenses charged should not control your verdict with respect to any other offense charged.

The verdict must represent the considered judgment of each juror. In order to return a verdict, it is necessary that each juror agree thereto. Your verdict must be unanimous.

It is your duty, as jurors, to consult with one another and to deliberate with a view to reaching an agreement, if you can do so without violence to individual judgment. Each of you must decide the case for yourself, but do so only after an impartial consideration of the evidence with your fellow jurors. In the course of your deliberations do not hesitate to re-examine your own views and change your opinion if convinced it is erroneous. But do not surrender your honest conviction as to the weight or effect of evidence solely because of the opinion of your fellow jurors, or for the mere purpose of returning a verdict.

You are not partisans. You are judges—judges of the facts. Your sole interest is to ascertain the truth from the evidence in the case.

There is nothing peculiarly different in the way a jury is to consider the proof in a criminal case from that in which all reasonable persons treat any question depending upon evidence presented to them. You are expected to use your good sense, consider the evidence for only those purposes for which it has been admitted, and give it a reasonable and fair construction in the light of your common knowledge of the natural tendencies and inclinations of human beings.

If the accused be proved guilty, say so; if proved not guilty, say so.

Keep constantly in mind that it would be a violation of your sworn duty to base a verdict upon anything but the evidence in the case.

Remember, also, that the question before you can never be: Will the Government win or lose the case? The Government always wins when justice is done, regardless of whether the verdict be guilty or not guilty.

The punishment provided by law for the offense charged in the indictment is a matter exclusively within the province of the Court, and is not to be considered by the jury in arriving at an impartial verdict as to the guilt or innocence of the accused.

Upon retiring to the jury room, you will select one of your number to act as foreman. The foreman will preside over your deliberations and be your spokesman in court.

A form of verdict has been prepared for your convenience. I shall now read the form of verdict which has been prepared for your convenience:

> "United States of America vs. Marvin Sherwin, No. 37990.
>
> "VERDICT
>
> "We, the jury, find Marvin Sherwin, the defendant at the bar _____ as to Count One, _____ as to Count Two, _____ as to Count Three, _____ as to Count Four, _____ as to Count Five, _____ as to Count Six."

And then there appears a line for the signature of the foreman. You will take this form to the jury room and when you have reached unanimous agreement as to your verdict, you will have your foreman fill in the blanks by using the words "guilty" or "not guilty", date and sign the form that states the verdict upon which you agree, and then return with your verdict to the courtroom.

If it becomes necessary during your deliberations to communicate with the Court, you may send a note by the bailiff. Never attempt to communicate with the

Court except in writing. And bear in mind always that you are not to reveal to the Court or any person how the jury stands, numerically or otherwise, on the question of the guilt or innocence of the accused, until after you have reached a unanimous verdict.

It is proper to add the caution that nothing said in these instructions—nothing in any form of verdict prepared for your convenience—is to suggest or convey in any way or manner any intimation as to what verdict I think you should find. I repeat, what the verdict shall be is the sole and exclusive duty and responsibility of the jury.

And now, gentlemen, the Court has completed its instructions to the jury, and unless counsel for the plaintiff or defendant have further or additional objections or exceptions to the Court's instructions as just given, I think it might be understood for the record that all objections and exceptions heretofore taken by counsel for the Government and counsel for the defendant will be considered as if said exceptions were made at this time and entered in the record and have the same force and effect as if repeated in full on all the grounds heretofore given.

Now, are there any additional objections or exceptions other than those heretofore stated?

MR. COONEY: I have no additional ones other than those stated the other day.

MR. BURNS: I have one, Your Honor.

THE COURT: Yes, Mr. Burns?

MR. BURNS: It should be made, I believe, in the absence of the jury.

THE COURT: Yes.

Ladies and gentlemen of the jury, the Court has not

as yet completed its instructions. In accordance with prescribed rules of procedure, you will retire to the jury room and the Court will give consideration to an additional matter, and will thereafter indicate to you whether or not its instructions have been completed and then indicate to you when you may retire for your deliberations.

You are excused for the moment, and the admonition which I heretofore gave you holds.

(Thereupon, the jury retired from the courtroom and the following proceedings were had.)

MR. BURNS: In one of the last instructions which Your Honor gave the jury, I have this comment to make. The instruction is this, in substance: you told the jury to exercise their common sense and if the defendant is proven guilty, say so; if the defendant is proved not guilty, say so.

THE COURT: Yes.

MR. BURNS: In my opinion, that instruction places a burden of proof upon the defendant which he does not have. I think the instruction should be, if the defendant has been proven guilty, say so, and if the proof fails to satisfy you beyond a reasonable doubt of the defendant's guilt, say so, rather than placing the burden of proof upon the defendant.

THE COURT: Very well. Mr. Burns, I might add that this instruction has been given innumerable times. It is one of the, shall I say, so-called classics set forth by Judge Mathis and reported for the benefit of judges throughout the country at various seminars and in the Federal Rules Decisions.

However, I am satisfied in my own mind that the

observation you have just made is a proper and correct one, and hence I shall cause the jury to be re-instructed with relation to that particular instruction.

Are there any other objections or exceptions?

MR. FOSTER: Two minor exceptions, Your Honor. At the commencement of the instructions Your Honor gave the standard instruction concerning the natural and probable consequences of a defendant's act, and it is my belief that that instruction is inapplicable in a case of this character.

THE COURT: I think it is clearly applicable in a case of this character.

MR. FOSTER: And the other objection which I would like to make, Your Honor, to Your Honor's instructions is to your comments upon the Tarman-Sherwin partnership income, which I believe is not a proper factor in the case. I believe Your Honor instructed that the jury could take into account any unreported income from the Tarman-Sherwin partnership—

THE COURT: "If you so find."

MR. FOSTER: "If you so find."

THE COURT: Yes. I accept the suggestion that has been made, and the jury may be recalled. I will have to find the particular numbered instruction.

MR. BURNS: Might I say on behalf of the defendant that the defendant is otherwise satisfied with the instructions and thanks Your Honor for the instructions, and likewise counsel thank you for the comment.

THE COURT: Thank you. I might say, Mr. Burns, it says, "if not proved guilty, say so", but I am accepting your observation. I feel that this is a very proper observation despite the fact that we have had a long history of use of this instruction. We have learned from

opinions from time to time that it is advisable to reconsider instructions given in the past.

MR. BURNS: As I heard the instruction, the word "not" was not used. It was "defendant proved not guilty" instead of "defendant not proved not guilty."

THE COURT: I shall put it in the form you have suggested, and I think it is a good suggestion.

MR. BURNS: Thank you. I assume Your Honor has in mind discharging the two alternate jurors?

THE COURT: Yes.

(Thereupon, the jury returned to the courtroom and the following proceedings were had.)

THE COURT: Ladies and gentlemen of the jury: during the recess counsel properly directed my attention to the fact that in a part of the recitation I apparently misplaced a "not" in one sentence. Apparently I said, "if the accused be proved guilty, say so; if proved not guilty, say so."

I should certainly correct this instruction because the fact of the matter is that if the evidence establishes the guilt of the accused beyond a reasonable doubt, you should say so: if, on the other hand, the evidence does not establish the guilt of the accused beyond a reasonable doubt, you should say so. So that with this clear correction in mind, the case is ready to go to you for your deliberation. This completes the instructions. I shall respectfully request that the two alternate jurors remain seated in the courtroom while the jury retires to conduct their deliberations.

So the jury, with the exception of the two alternates, will now retire to the jury room.

(Thereupon, at the hour of 10:55 a.m., the jury retired to deliberate upon its verdict.)

Appellant's Proposed Instruction No. 19

SUBJECT: Wilfulness.

You are instructed that in common, everyday speech, "wilful" denotes an act which is intentional, knowing or voluntary, as distinguished from accidental, but when it is used in a criminal statute, where one of the elements is a specific intent to defraud, it has a somewhat different meaning. It generally means an act done with a bad purpose, without justifiable excuse. The word "wilful" is also used to characterize a thing done without ground for believing it is lawful.

You are instructed that the thing done is not necessarily and under all circumstances required to be lawful. It is sufficient to exculpate and exonerate a defendant if it is honestly believed to be lawful. Or to put it conversely, it is unlawful if it is done without grounds for believing in its lawfulness.

If an act is done in good faith, based upon an actual belief of a defendant, even if such belief is a mistaken one, or a negligent one, or if such defendant is in ignorance of either facts or law rendering it unlawful; and, if you believe that the defendant, Marvin Sherwin, honestly made a mistake, honestly was negligent and honestly was ignorant of the facts or ignorant of the law, you will then determine that his conduct in doing what he did was not wilful.

Authority: *U. S.* v. *Murdock,* 290 U.S. 389.

No. 18,203

In the United States Court of Appeals for the Ninth Circuit

ESTATE OF E. W. CHISM, Deceased, CLARA CHISM, Executrix, and CLARA CHISM, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

---

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases:

Cases—Continued Page

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 164-189) are not officially reported.

JURISDICTION

This petition for review (R. 196-200) involves federal income taxes for the years 1952 through 1956. By his notice mailed to taxpayers [1] on March 6, 1959

[1] For convenience, Clara Chism and the estate of E. W. Chism, deceased, will be referred to collectively as the taxpayers.

(R. 10-19), the Commissioner determined deficiencies for the above years in the following amounts (R. 11):

Year	Amount
1952	$ 4,557.10
1953	3,388.92
1954	3,000.50
1955	3,233.48
1956	1,503.00
Total	$15,683.00

Within 90 days thereafter and on May 11, 1959, taxpayers filed a petition for redetermination with the Tax Court, pursuant to Section 272(a) of the Internal Revenue Code of 1939 and Section 6213 of the Internal Revenue Code of 1954. (R. 1, 3-7.) The decision of the Tax Court (R. 195), entered on April 27, 1962, affirmed the Commissioner's determination. On July 27, 1962, taxpayers filed a petition for review with this Court. (R. 196-200.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.[2]

QUESTIONS PRESENTED

Whether the Tax Court erred in holding that:

1. The withdrawals made by taxpayers from their family-owned corporation were informal dividends and not loans;

2. The assessment against taxpayers for the year

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[2] The instant case was consolidated for trial with the companion case of *Chism Ice Cream Co.* v. *Commissioner*, Docket No. 80199. A petition for review was not filed in the latter case.

1952 was not barred by the statute of limitations; and

3. None of the salary received by E. W. Chism in 1952 and 1953 was excludable from gross income as amounts received under a wage continuation plan.

STATUTES INVOLVED

Internal Revenue Code of 1939:

> SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.
>
> Except as provided in section 276—
>
> (a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.
>
> * * * *
>
> (c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.
>
> * * * *
>
> (26 U.S.C. 1952 ed., Sec. 275.)
>
> SEC. 276. SAME—EXCEPTIONS.
>
> * * * *
>
> (b) *Waiver.*—Where before the expiration of the time prescribed in section 275 for the assess-

ment of the tax, both the Commissioner and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

* * * *

(26 U.S.C. 1952 ed., Sec. 276.)

SEC. 322. REFUNDS AND CREDITS.

* * * *

(b) *Limitation on Allowance.*—

(1) *Period of limitation.*—Unless a claim for credit or refund is filed by the taxpayer within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, no credit or refund shall be allowed or made after the expiration of whichever of such periods expires the later. If no return is filed by the taxpayer, then no credit or refund shall be allowed or made after two years from the time the tax was paid, unless before the expiration of such period a claim therefor is filed by the taxpayer.

* * * *

(3) [as added by Sec. 169(a), Revenue Act of 1942, c. 619, 56 Stat. 798.] *Exceptions in the case of waivers.*—If both the Commissioner and the taxpayer have, within the period prescribed in paragraph (1) for the filing of a claim for credit or refund,

agreed in writing under the provisions of section 276(b) to extend beyond the period prescribed in section 275 the time within which the Commissioner may make an assessment, the period within which a claim for credit or refund may be filed, or credit or refund allowed or made if no claim is filed, shall be the period within which the Commissioner may make an assessment pursuant to such agreement or any extension thereof, and six months thereafter, except that the provisions of paragraph (1) shall apply to any claim filed, or credit or refund allowed or made, before the execution of such agreement. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 322.)

STATEMENT

The basic facts as stipulated (R. 22-29) and as found by the Tax Court (R. 167-179) may be summarized as follows:

E. W. Chism organized the Chism Ice Cream Company (hereinafter called the Company) in 1933 as successor to a sole proprietorship of the same name which he had founded in 1905. The Company engaged in the manufacture and sale of ice cream and carbonated beverages, and Chism was the president of the Company continuously from the time of its incorporation until his death on December 27, 1956. During the years 1952 through 1956, his daughter, Alice Jane Frazer, was the vice-president and his wife Clara, was the secretary of the Company. The

board of directors consisted of Chism, his wife and his daughter, and during the years in question all of the Company's issued and outstanding common stock was owned by Chism (71,500 shares), his wife (67,500 shares) and his daughter (51,000 shares). (R. 168, 169, 170.)

The following statement shows, for the years 1938 through 1958, the Company's earned surplus, the amounts of all formal dividends declared and paid, and the salaries paid to the Chism family (R. 25-26, 171, Ex. 1-A):

Year	Earned Surplus (Nearest Thousand)	Dividends declared and paid	Salaries paid (Nearest Thousand) E. W. Chism	Clara Chism	Alice Jane Frazer
1938	$ 23,000	None	$ 9,000	None	None
1939	44,000	None	9,000	None	None
1940	61,000	None	9,000	None	None
1941	61,000	None	9,000	None	$1,000
1942	93,000	None	9,000	None	1,000
1943	118,000	None	9,000	None	1,000
1944	146,000	None	9,000	None	1,000
1945	161,000	None	15,000	None	2,000
1946	166,000	$587.00	18,000	None	2,000
1947	173,000	None	18,000	None	2,000
1948	182,000	None	18,000	None	3,000
1949	215,000	None	20,000	None	4,000
1950	234,000	None	24,000	None	5,000
1951	224,000	None	24,000	None	5,000
1952	228,000	None	24,000	None	5,000
1953	267,000	None	24,000	None	5,000
1954	287,000	None	24,000	None	5,000
1955	285,000	None	24,000	None	5,000
1956	294,000	None	24,000	None	5,000
1957	309,000	None	*	$24,000	5,000
1958	314,000	None	*	24,000	5,000
1959	305,000	None	*	24,000	7,000

* Chism died on December 27, 1956.

Up until 1952, the progress and success of the Company was attributable principally to the personal

efforts of Chism. The business grew from a one-man operation at the time of its founding in 1905 to a modern, mechanized ice cream and carbonated beverage enterprise, having between 50 and 75 employees. However, after the beginning of 1952, Chism was physically incapacitated and was confined almost entirely to his home as the result of a heart ailment which began in about 1948 and which recurred in more serious form during 1951. Thereafter, he continued to be the Company's president, but his activities were confined principally to occasional visits of one-half hour or so to the Company's office, accompanied by a nurse. After 1953, he was confined entirely to his home, where from time to time he had conferences regarding business matters with the Company's general manager, Walther, who had assumed responsibility for the Company's day-to-day operations. (R. 172-173.)

Notwithstanding that Chism was incapacitated physically after 1951, and that the amount of his services to the business thereafter declined steadily, the Company continued to pay him either the same or increased amounts of salary for the years 1952 through 1956. All of the salary so paid for those years was treated by the Company as "salary" in its books and in its corporate income tax returns. (R. 173.)

During the years 1935 through 1958, Chism or his wife made numerous withdrawals from the Company, and also made certain repayments with respect thereto. These withdrawals and repayments were re-

corded in the Company's books in an account entitled "E. W. Chism—Note Receivable." Actually, no promissory notes or other written instruments evidencing such withdrawals were ever executed or delivered to the Company. Also, no interest was ever charged or paid on the outstanding balance, and no collateral security therefor was ever given. (R. 173-174.) The total withdrawals and repayments were as follows (R. 174, Ex. 2-B):

Year	Withdrawals	Repayments	Balance
1935–1946	$43,017.77	$24,090.95	$18,926.82
1947	------	------	18,926.82
1948	6,584.45	1,200.00	24,311.27
1949	1,500.00	------	25,811.27
1950	1,500.00	2,803.25	24,508.02
1951	7,500.00	1,720.17	30,287.85
1952	10,046.90	------	40,334.75
1953	7,821.16	------	48,155.91
1954	10,213.88	------	58,369.79
1955	12,565.81	------	70,935.60
1956	7,300.00	------	78,235.60
1957	------	------	78,235.60
1958	------	78,235.60*	

* The "repayment" shown for the year 1958 was made by the estate of E. W. Chism, as hereinafter shown.

All of the withdrawals were made informally, and they were not earmarked by the Company for application to medical expenses. There is no indication on the Company's books or elsewhere that the payments were made pursuant to any health insurance plan. The employees of the Company were not notified or advised of the existence of any such plan, nor did they have any right to demand benefits under a plan. (R. 174-175.)

Sometime prior to April, 1957, a revenue agent, who was examining the returns of the taxpayers and the Company for the years here involved, discussed with the Company's accountant the possibility of treating the withdrawals for those years as informal dividends. The accountant then discussed this matter with Chism's wife and Walther, and it was the accountant's feeling that something should be done to "clean up" the balance in the above-mentioned account. Thereafter, on April 25, 1957, the Company filed a claim, signed by Mrs. Chism as secretary of the Company (Ex. 5), against the estate of E. W. Chism for the amount of the then outstanding balance of $78,235.60 in the account. The claim was approved by Mrs. Chism as executrix of the estate (Ex. 5), and subsequently allowed by the probate court in Reno, Nevada. The amount of the claim, without interest, was paid in full to the Company by the estate on October 20, 1958. (R. 175.)

The Company did not at any time have any formal plan of "health insurance" for its officers or employees, nor did it have any formal salary or wage continuation plan. However, it did on seven occasions during the 20-year period of 1941 through 1960 pay all or part of the wages of employees who were temporarily ill or who had surgical operations. In all of these cases except two, the amounts paid as wages to the employee during his illness ranged from $449 to $875, and in the other two cases the amounts so paid were respectively, $2,650 and $4,770.39. (R. 175-176, Ex. 9.)

Chism and his wife filed their joint income tax return for the year 1952 on March 14, 1953, wherein they reported gross income in the amount of $25,-141.37. (R. 178, Ex. 6-D.) This amount did not include any portion of the $10,046.90 withdrawn from the Company that year which the Commissioner and the Tax Court determined to be includible in their gross income for the year as "informal dividends". On November 13, 1957, which was more than three but less than five years after the filing and due date of the return, Mrs. Chism, acting both individually and as executrix of Chism's estate, entered into a consent agreement (Treasury Form 872) with the Commissioner, under which the time for making any assessment for the year 1952 was extended to June 30, 1959. (R. 178, see Ex. 6-D.) The deficiency notice pertaining to the years 1952 through 1956 was issued on March 6, 1959. (R. 10, 178.)

At the completion of the trial, the Tax Court made the following ultimate findings (R. 178-179):

1. Reasonable allowances to the Company for salaries paid to Chism for the years 1953, 1954, 1955, and 1956 were $20,000, $15,000, $12,000 and $12,000, respectively.

2. The withdrawals made by Chism and his wife from the Company during the years 1952 through 1956 constituted informal dividends.

3. The Company did not have a health insurance plan in effect during any of the years here involved.

4. The deficiency assessment against Chism and his wife for the year 1952 was not barred by the statute of limitations.

On the basis of the above findings, the Tax Court held (R. 186) that the withdrawals were includible in the gross income of Chism and his wife as informal dividends and were not excludable therefrom either as loans or as health insurance plan payments. The Tax Court also rejected (R. 182, 189) taxpayers' arguments (1) that part of the salary received by Chism in 1952 and 1953 was excludable from his gross income as amounts received under a wage continuation plan and (2) that the assessment against Chism and his wife for 1952 was barred by the statute of limitations.[3]

SUMMARY OF ARGUMENT

1. Whether withdrawals from a corporation by a stockholder are dividends or loans has uniformly been held to be a question of fact to be decided on consideration of all the circumstances. In the instant case it is readily apparent that Chism treated the earnings of the ice cream company as his own by withdrawing substantial amounts therefrom on open account over a period of approximately 25 years, resulting in an outstanding balance in the account in

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[3] In the companion case of *Chism Ice Cream Co.* v. *Commissioner*, the Tax Court held (1) that the excessive compensation paid to Chism was not deductible by the Company either as salary or health insurance payments and (2) that the premiums paid by the Company on a retirement income policy covering the life of its general manager were not deductible by the Company because it was the "direct beneficiary" of the policy. No appeal was taken from that decision.

the amount of $78,235.60 as of the end of 1956. The relevant facts overwhelmingly support the finding of the Tax Court that the withdrawals were dividends and not loans.

There were no notes given, no interest was charged and no collateral was required. The withdrawals were substantial, and any repayments occasional and insubstantial, with no repayments at all being made during the five years in question. There was no evidence of any intention on his part to repay the withdrawals, nor did the Company at any time during his life take steps to enforce payment. The corporation's stock was owned entirely by Chism and his immediate family and his control of the corporation was reinforced by the fact that his wife and daughter were officers and directors of the corporation. Finally, even though the corporation's earned surplus exceeded $200,000 during the years in question, no formal dividends were ever paid or declared.

The fact that the Company's claim for the outstanding balance was allowed against Chism's estate by the local probate court after an examination of his returns by a revenue agent had begun did not preclude the Tax Court from determining his tax liability. A nonadversary proceeding in a state court which is collusive in the sense that the parties seek to adversely affect the Government's right to additional income taxes is not binding on the federal courts.

2. The special five-year period of limitations applies to taxpayers' 1952 return because they failed to report more than 25 percent of their gross income

therein. Moreover, prior to the expiration of the five-year period, taxpayers consented to an extension of time within which the Commissioner could assess a deficiency. The Commissioner's deficiency notice was within the extended period and was not barred by the statute of limitations. Taxpayers argument that the consent agreement is invalid because it did not also extend the time within which a claim for refund could be filed is unsupported by authority and is manifestly without merit.

3. The Tax Court's finding that the ice cream company did not have a health or wage continuation plan for its employees is not clearly erroneous. The payments made to Chism by the Company were not earmarked or treated as health payments by the Company, but were carried on the books as "salary" and deducted as such in the Company's income tax returns. Employees were not advised of the existence of a plan and had no right to demand benefits under any such plan. Whether or not payments would be made, and the amount and duration thereof, was within the discretion of the Company's management and could be changed at will. The fact that the Commissioner mistakenly allowed a deduction for wage continuation payments for the years 1954 through 1956 does not mean that a plan existed during those years or during any prior years. The Commissioner does not concede the existence or accuracy of the facts upon which deductions are based by accepting or acquiescing in tax returns.

ARGUMENT

I

The Finding of the Tax Court That the Withdrawals Were Dividends and Not Loans Is Not Clearly Erroneous

The main question on this appeal is whether the Tax Court erred in holding that the withdrawals by E. W. Chism from the family-owned corporation were in fact dividends and not loans. Since this is a question of fact to be determined upon a consideration of all the circumstances present in a particular case, the lower court's decision should not be disturbed unless it is clearly erroneous. *Clark* v. *Commissioner*, 266 F. 2d 698 (C.A. 9th); *Roschuni* v. *Commissioner*, 29 T.C. 1193, affirmed *per curiam*, 271 F. 2d 267 (C.A. 5th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783.[4]

In determining whether a withdrawal is a loan or a dividend, numerous factors are relevant although no one of them may be controlling. The factors generally considered by the courts are as follows: (1) whether the corporation is closely held and controlled (*Roschuni*, *supra*; *Baird* v. *Commissioner*, 25 T.C. 387; *Wilson* v. *Commissioner*, 10 T.C. 251, affirmed, 170 F. 2d 423 (C.A. 9th)); (2) whether notes are given and interest charged (*Clark* v. *Commissioner*, *supra*; *Oyster Shell Products Corp.* v. *Commissioner*,

[4] See Section 7482(a), Internal Revenue Code of 1954; Rule 52(a), Federal Rules of Civil Procedure; *Commissioner* v. *Duberstein*, 363 U.S. 278, 289; *Wentworth* v. *Commissioner*, 244 F. 2d 874 (C.A. 9th).

(C.A. 2d), decided February 13, 1963 (11 A.F.T.R. 2d 777); *United States* v. *E. Regensburg & Sons*, 221 F. 2d 336, 337 (C.A. 2d)); (3) whether collateral is given to secure the purported loans (*Levy* v. *Commissioner*, 30 T.C. 1315; *Crispin* v. *Commissioner*, 32 B.T.A. 151); and (4) whether the withdrawals are periodic and at will with a steadily mounting balance (*Regensburg* v. *Commissioner*, *supra*; *Baird* v. *Commissioner*, *supra*; *Meyer* v. *Commissioner*, 45 B.T.A. 228). Other factors relevant, depending upon the circumstances of each case, are whether there is a definite time for repayment or a ceiling on the amount that can be withdrawn; whether there is any effort to enforce collection on the part of the company or any plan for repayment by the stockholders; and whether the corporation has customarily declared and paid formal dividends. See *Niederkrome* v. *Commissioner*, 266 F. 2d 238 (C.A. 9th); *Wiese* v. *Commissioner*, 93 F. 2d 921 (C.A. 8th), certiorari denied, 304 U.S. 562; *Spheeris* v. *Commissioner*, 284 F. 2d 928 (C.A. 7th); *Goodman* v. *Commissioner*, 23 T.C. 288; *Simmons* v. *Commissioner*, 26 T.C. 409; *Kinnear* v. *Commissioner*, 36 B.T.A. 153; *Mellon* v. *Commissioner*, 36 B.T.A. 977; *Murchison* v. *Commissioner*, 32 B.T.A. 32; *Marshall* v. *Commissioner*, 32 B.T.A. 956; *Hunt* v. *Commissioner*, 6 B.T.A. 558; 1 Mertens, Law of Federal Income Taxation (Rev.), Sec. 9.21.

A. *Substantial evidence supports the decision*

In the instant case, the opinion of the court below (R. 164-189) recites more than enough facts to support its decision. In the first place, the taxpayers,

along with their daughter, controlled the corporation: Chism was president of the Company, his daughter was vice president, and his wife was the secretary; all three comprised the board of directors, and all three owned all the issued and outstanding stock of the Company. (R. 168-170.) In the second place, the withdrawals were continuous, substantial and apparently in whatever amounts the taxpayers desired. (R. 174.) In the third place, no notes were given for the amounts received, no interest was charged, and no security was given. (R. 174.) In the fourth place, this practice continued for a period of 22 years, and the net amount of withdrawals increased steadily and in considerable amounts, totalling $78,235.60 by the end of 1956.[5] (R. 174.) In the fifth place, even though the Company's earned surplus was in excess of $100,000 beginning in 1943, and over $200,000 during the years involved, no formal dividends were ever declared or paid, with the ex-

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[5] In an analogous situation, in *Baird* v. *Commissioner, supra,* the Tax Court stated the following (p. 394):

> The fact that the individual debit balances were allowed to mount steadily each year without any substantial repayment thereon for more than 20 years until they reached a total net withdrawal balance of approximately $98,000 *is inconsistent with an intent to borrow and repay.* * * * The tax saving which would result, if petitioners' techniques were approved, is obvious, and the motive is by the same token apparent. [Emphasis added.]

See to the same effect, *Regensburg* v. *Commissioner, supra; Roschuni* v. *Commissioner, supra.*

ception of a $587 dividend in 1946.[6] (R. 171.) In the sixth place, there was no arrangement to repay the ever-increasing balances in fixed amounts or at a definite time in the future, nor did the Company, at any time during Chism's life, take any steps to enforce repayment. (R. 185.) Finally, repayments were unsubstantial and sporadic, with no repayments at all being made during the years in question. (R. 174.)

The foregoing, fully supported by the record, presents an overwhelming picture of the owners of a family corporation siphoning off corporate earnings for their own personal use without any plan of reimbursement.

Taxpayers' argument (Br. 14-30) that the withdrawals were "loans" does not merit extended discussion. The balance in the drawing account was paid in full by Chism's estate in 1959, but this was done only after a revenue agent had suggested the possibility of treating the withdrawals as dividends. (R. 185-186.) It is the intention at the time the withdrawals are made which is determinative (*Clark* v. *Commissioner*, *supra*), and that intention cannot be conveniently changed by subsequent events. Courts view with a jaundiced eye the repayment of the alleged debts after an examination of the returns has begun. See, *Regensburg* v. *Commissioner*, *supra*; *Roschuni* v. *Commissioner*, *supra*; *Baird* v. *Commis-*

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[6] The only other formal dividends paid in the history of the Company were during 1936 and 1937 (R. 25), and these, according to Mr. Walther (R. 77) were prompted by the undistributed profits tax in effect at that time.

sioner, supra; Meyer v. *Commissioner, supra; Continental Machine & Tool Corp.* v. *Commissioner*, decided April 25, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,096).

The only evidence of an intention to repay is the vague and inconclusive testimony of Mrs. Chism (R. 102-103, 109), which falls far short of establishing a plan or intention of repaying. At most, the record supports no more than a conclusion that taxpayers "hoped to" (R. 103) repay the withdrawals, although they did not have the money to do so. (R. 109). The absence of resources with which to repay the withdrawals was held to be a relevant fact in the *Baird, Meyer, Regensburg* and *Marshall* cases, *supra.*

The fact that the withdrawals were designated on the Company's books and financial statements as loans is not enough to establish the character of the withdrawals (*Clark* v. *Commissioner, supra*), nor is it significant that the withdrawals were not strictly proportionate to stock holdings (*Roschuni* v. *Commissioner, supra*), especially since the stockholders here are all in the same family.

The practice indulged in by the taxpayers, of continuously withdrawing amounts on open account over a substantial period of time with an ever-increasing balance, is readily recognized by the courts as " 'an established method of dividend distribution' " in closely held corporations. *Regensburg* v. *Commissioner, supra*, p. 44.

B. *The Tax Court was not bound by the order of the probate court*

The fact that the Company's claim against Chism's estate for the amount of the outstanding balance in the withdrawal account was allowed by the probate court of Washoe County, Nevada, as a debt of the estate did not preclude the Tax Court from deciding that, for federal tax purposes, the withdrawals should be classified as dividends and not loans, because the judgment of the Probate Court was not entered in a bona fide adversary proceeding after a hearing on the merits and because it was collusive in the sense that the parties sought a decision which would adversely affect the Government's right to additional income taxes. This rule was succinctly stated by this Court in *Wolfsen* v. *Smyth*, 223 F. 2d 111, 113-114:

> This court recently held in *Newman* v. *Commissioner of Internal Revenue*, 222 F. 2d 131, that an order of a state court that adversely affects the tax right of the United States and which is based upon a nonadversary proceeding, does not foreclose the federal courts from determining the tax liability.

To the same effect, see *Estate of Rainger* v. *Commissioner*, 183 F. 2d 587 (C.A. 9th), affirming *per curiam* 12 T.C. 483.[7]

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[7] See also, *In re Sweet's Estate*, 234 F. 2d 401, 404 (C.A. 10th), certiorari denied, 352 U.S. 878; *Faulkerson's Estate* v. *United States*, 301 F. 2d 231 (C.A. 7th), certiorari denied, 371 U.S. 887; *Brainard* v. *Commissioner*, 91 F. 2d 880, 883-884 (C.A. 7th), dismissed, 303 U.S. 665; *Stallworth's Estate* v. *Commissioner*, 260 F. 2d 760, 763 (C.A. 5th);

The claim filed on behalf of the Company was signed by Mrs. Chism as secretary of the Company, and was approved for repayment on behalf of the estate by Mrs. Chism acting as executrix thereof. (R. 185, Ex. 5.) The result is a classic example of a consent decree. Moreover, since the claim was filed after a revenue agent had examined the returns and suggested the possibility of treating the withdrawals as dividends (R. 185-186), it can reasonably be inferred that the proceeding was "collusive in the sense that all parties in effect * * * sought a decision which would adversely affect the Government's right to additional income tax." *Freuler* v. *Helvering*, *supra*, p. 45; *Wolfsen* v. *Smyth*, *supra*, pp. 113-114.

None of the cases cited by the taxpayers (Br. 17-29) support their contention that the Tax Court was conclusively bound by the order of the probate court (Ex. 5) which allowed as a debt the Company's claim against Chism's estate for the balance shown in the withdrawal account.

In *Blair* v. *Commissioner*, 300 U.S. 5, there was an adversary proceeding on the merits between the trustees and the beneficiary with no "basis for a charge that the suit was collusive * * *" (p. 10). In *Freuler* v. *Helvering*, 291 U.S. 35, 45, the Court noted that "The decree purports to decide issues regularly submitted and not to be in any sense a

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Saulsbury v. *United States*, 199 F. 2d 578, 580 (C.A. 5th); *Regensburg* v. *Commissioner*, *supra*; *Cenedella* v. *United States*, 224 F. 2d 778 (C.A. 1st); *Freuler* v. *Helvering*, 291 U.S. 35.

consent decree" and held further that the state court proceedings were *not* "collusive".

This Court's decision in *Henricksen* v. *Baker-Boyer Nat. Bank*, 139 F. 2d 877 is not in point. There, the state court decree, interpreting the meaning and effect of a will, was rendered upon a consideration of the merits in an adversary proceeding with no evidence of collusion in the sense that the parties sought to adversely affect the tax rights of the Government. The rule in this Circuit, which controls the disposition of the instant case, is stated in the *Wolfsen* and *Rainger* cases, *supra*, and in *Newman* v. *Commissioner*, 222 F. 2d 131 (C.A. 9th).

Taxpayers cite the Third Circuit case of *Gallagher* v. *Smith*, 223 F. 2d 218, as authority for their contention that the federal courts are conclusively bound by decrees of inferior state courts "whether or not they are adversary." (Br. 24.) We know of no reported case which so holds and, moreover, it is clear that the Third Circuit did not enunciate such a principle of law. The Third Circuit expressly qualified the language of its opinion as follows (pp. 224-225):

> Whatever may be the case with respect to consent decrees, however, it is clear that if the question is *fairly presented* to the state court for its *independent decision and is so decided* by the court the resulting judgment if binding upon the parties under the state law is conclusive as to their property rights in the federal tax case, regardless of whether they occupied adversary positions in the state court or were all on the same side of the question. [Emphasis added.]

Furthermore, *Gallagher* does not hold that every nonadversary proceeding in an inferior court, *ipso facto*, forecloses any inquiry by the federal courts as to the validity of the decree; the court stated immediately following the above quotation (p. 225):

> It is clear, as suggested by the Supreme Court in the *Freuler* and *Blair* cases, that a state judgment obtained by *collusion to defeat a federal tax need not be given conclusive effect* in a suit in a federal court involving that tax. And the *nonadversary character of a state suit is undoubtedly relevant as evidence of such collusion.* [Emphasis added.]

Even under *Gallagher*, therefore, the Tax Court was not conclusively precluded from determining the tax liability involved here.

It is readily apparent that the claim against Chism's estate was a mere afterthought and an obvious attempt by taxpayers to extricate themselves from the tax consequences of their past actions. Their contention now, that the Tax Court was bound by the order of the probate court, is unsupported by authority.

To sum up, all that the taxpayers have come up with to meet their affirmative burden of showing that the Tax Court's decision is clearly erroneous is that the net balance in the withdrawal account was paid by Chism's estate after the revenue agent suggested treating the withdrawals as dividends, some general testimony by Mrs. Chism that she "hoped to" repay the amounts, and the fact that the withdrawals were designated as loans on the Company's books and

financial statements. On the other hand, it would be difficult to find a stronger array of relevant facts than those recited by the court below to show that the withdrawals were in fact the distribution of earnings and profits of the corporation, and not loans.

II

The Assessment Against Taxpayers for the Year 1952 Was Not Barred By the Statute of Limitations

Under the 1939 Code, the Commissioner has three years from the date the return is filed within which to assess a deficiency. Sec. 275(a) of the 1939 Code, *supra*. However, if the taxpayer omits from his return more than 25 percent of the gross income properly includible therein, then the Commissioner has five years from the date the return is filed within which to assess a deficiency. Sec. 275(c) of the 1939 Code, supra. In either case, the period of limitations may be extended by written waiver executed by the taxpayer within the statutory or any extended period of limitation. See Section 276(b), *supra*.

The five-year period of limitations applies in the instant case because the taxpayers omitted more than 25 percent of their gross income from their 1952 return. (R. 188.) Furthermore, prior to the expiration of the five-year period, Mrs. Chism, acting both individually and as executrix of Chism's estate, entered into a consent agreement with the Commissioner under which the period for assessment of the deficiency for the year 1952 was extended to June 30, 1959. (R. 188-189, Ex. 6-D.) The Com-

missioner's deficiency notice, issued on March 6, 1959 (R. 10, 27), was within the extended period and is clearly not barred by the statute of limitations. *Azevedo* v. *Commissioner*, 246 F. 2d 196 (C.A. 9th).

Taxpayers' argument (Br. 38-44) that the consent signed by Mrs. Chism is invalid because it lacked "mutuality" is without substance. A consent agreement extending the time within which the Commissioner may make an assessment also extends the time within which a claim for refund may be filed *provided* the consent is signed within the period prescribed by Section 322(b)(1), *supra*, namely, within three years from the time the return was filed or within two years from the time the tax was paid, whichever is later. See Sec. 322(b)(3) of the 1939 Code, *supra*.[8] Since the consent was not filed prior to March 15, 1956 (three years from the date the return was filed), but rather on November 13, 1957 (R. 27), the taxpayers were not entitled to an extension of time within which to file their refund claim for 1952. There is no provision comparable to Section 322(b)(3) for consents signed *after* the period of time provided in Section 322(b)(1); taxpayers' argument that there *should be* is best addressed to Congress rather than the courts.

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[8] Here, the return is considered filed and the tax paid on March 15, 1953. See Treasury Regulations 118 (1939 Code), Sec. 39.322-7(b).

III

None of the Salary Received By Chism In 1952 and 1953 Is Excludable From Gross Income As Amounts Received Under a Wage Continuation Plan

As noted above, the instant case involving Chism and his wife was consolidated for purposes of trial with a companion case involving the family-owned corporation, i.e., the Chism Ice Cream Company.[9] In the companion case, the Company sought, among other things, to deduct the full amount of salary paid to Chism during the years 1953 through 1956 on the grounds that the amounts constituted reasonable compensation or, in the alternative, that if some of the salary was unreasonable, then all or part of the excess salary was deductible as "health insurance payments." (R. 166.) The Tax Court found that of the salary paid, the following amounts were excessive and not deductible, being, in essence, "informal dividends" to Chism and his wife as stockholders (R. 171, 178, 179, 181):

1953	$ 4,000
1954	$ 9,400
1955	$12,210
1956	$12,210

The court also found (R. 175, 179) that the Company did not have a health insurance plan or a wage continuation plan in effect during any of the tax

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[9] Taxpayers' charge of an inconsistency in the Tax Court's findings in that case is baseless on its face, since it recognizes and quotes the court's distinction between formal dividends and informal dividends (Br. 30-31) before attempting to ignore that distinction (Br. 32).

years involved and, accordingly, rejected the Company's alternative argument that the excessive compensation was deductible as health insurance payments.

In the instant case, Chism and his wife contended below that the withdrawals were excludable from gross income either as loans or as health insurance plan payments. The Tax Court held that the withdrawals constituted informal dividends, rejecting taxpayers' argument that they were excludable either as loans or as health benefits.

Taxpayers now argue (Br. 44-48) that the Tax Court's finding that the Company did not have a health insurance plan or a wage continuation plan is clearly erroneous, and that at least $5,200 of the salary received by Chism in each of the years 1952 and 1953 should be excludable from gross income as amounts received under a wage continuation plan. This contention is without merit because the Tax Court's finding that no plan existed is amply supported by the record.

For instance, none of the payments made to Chism during the years involved were earmarked by the Company for application to medical expenses. Nor is there any indication on the Company's books or elsewhere that the payments were made pursuant to any health plan. (R. 174-175.) On the contrary, the amounts were reflected on the Company books and records as "salary" (R. 24, Ex. 1-A) and deducted as such on the Company's income tax returns (Ex. 8-F). Mr. Walther testified (R. 78) and the Tax Court found (R. 175) that the employees of the

Company were never notified or advised of the existence of a health or wage continuation plan, nor did they have any right to demand benefits under any such plan. If any rights existed, they could be varied at will by management. (R. 78.)

To support their contention that a plan existed in 1952 and 1953, taxpayers argue (Br. 44) that the Commissioner "conceded" the existence of a plan for the years 1954 through 1956 because he failed to disallow the deductions taken in those years for amounts claimed to have been received under a wage continuation plan. (See Ex. 7-E.) However, taxpayers cite no authority, nor can any be found, for the proposition that by accepting a tax return the Commissioner *concedes* the existence or accuracy of certain facts upon which the deductions are based. It is well known that mere acceptance of or acquiscence in tax returns for prior years creates no estoppel against the Commissioner (*Niles Bement Pond Co.* v. *United States*, 281 U.S. 357; *Caldwell* v. *Commissioner*, 202 F. 2d 112 (C.A. 2d)), nor does it preclude him from reaching a different conclusion for the current year either on questions of law or questions of fact (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180). The rationale of the estoppel cases precludes the mere acceptance of tax returns from being considered a concession by the Commissioner.

Finally, the fact that the Company may have paid half-time or full-time wages for limited periods to some seven employees during its 27 years of existence (see Ex. 9) does not elevate an apparently dis-

cretionary policy to the dignity of a *plan* for federal tax purposes. See *Haynes* v. *United States*, 353 U.S. 81, and *Epmeier* v. *United States*, 199 F. 2d 508 (C.A. 7th), for examples of informal plans prior to the 1954 Code.

It is apparent from the record as a whole that taxpayers here sought to siphon off the earnings of their family-owned corporation in the form of salaries and so-called "loans," in an attempt to reduce taxes, both to the Company by means of a deduction for salaries and to themselves by treating the withdrawals as loans. Their argument now, that the "informal dividends" which they received in the form of excessive compensation and so-called "loans" were in fact amounts received pursuant to a health or wage continuation plan, is patently without substance.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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MARCH, 1963.

Certificate

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated.....day of....., 1963.

Attorney

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No. 18,203

IN THE

United States Court of Appeals

For the Ninth Circuit

ESTATE OF E. W. CHISM, Deceased, Clara Chism, Executrix, and CLARA CHISM,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

PETITION FOR REHEARING ON BEHALF OF PETITIONERS

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Table of Authorities Cited

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Codes

Regulations

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On Petition for Review of the Decision of the Tax Court of the United States

PETITION FOR REHEARING ON BEHALF OF PETITIONERS

To the Honorable William E. Orr, Frederick G. Hamley, and James R. Browning, Circuit Judges:

Petitioners respectfully petition for a rehearing of the judgment entered by this Court against them on July 30, 1963.

The basis for this petition is the Court's error in assuming, without supporting citations, that the operation of Sections 22(a), I.R.C. 1939, and 61(a)(7), I.R.C. 1954 are not "dependent upon state law". (Op. 5). Upon this faulty first premise, this Court has held that moneys withdrawn under a binding legal obligation to repay them under the law of Nevada could constitute taxable income under federal law. But this is simply not so. Sections 22(a), I.R.C. 1939, and 61(a)(7), I.R.C. 1954, do not reach funds received by a taxpayer under an obligation to repay them. *United States v. Kirby Lumber Co.* (1931), 284 U.S. 1, 52 S.Ct. 4; *Woodsam Associates, Inc. v. Commissioner* (C.A. 2, 1952), 198 F.2d 357, 359; *Commissioner v. Gross* (C.A. 2, 1956), 236 F.2d 612, 615, 618; *Simon v. Commissioner* (C.A. 3, 1960), 285 F.2d 422; Treasury Regulations, § 1.61-12(c). The only inroad that has been made to this rule is in the case of embezzlers: for years they too were sheltered from the incidence of Section 22(a), I.R.C. 1939, because the embezzler "was at all times under an unqualified duty and obligation to repay the money to his employer." *Commissioner v. Wilcox* (1946), 327 U.S. 404, 408, 66 S.Ct. 546, 549. In overruling the *Wilcox* case the opinion of Chief Justice Warren for the Supreme Court carefully excepted from the application of the new rule for embezzlers any moneys received subject to a "*consensual*" obligation to repay. The language of the Court was simple: "*it* (the broad sweep of 'gross income') *excludes loans.*" (Emphasis ours). *James v. United States* (1961), 366 U.S. 213, 219, 81 S.Ct. 1052, 1055.

But how do we determine whether or not funds have been received as a loan? Do we look to federal law, as

this Court has stated (Op. 4-5), or do we look to state law? We look to state law. Thus in *Wilcox, supra*, the Supreme Court found that the embezzler Wilcox had received no taxable income because "(u)nder *Nevada* law, the crime of embezzlement was complete whenever an appropriation was made; the employer was entitled to replevy the money as soon as it was appropriated (citing *Nevada* statutes) or to have it summarily restored by a magistrate (citing *Nevada* statutes). The employer, moreover, at all times held the taxpayer liable to return the full amount. The debtor-creditor relationship was definite and unconditional." (Emphasis added). *Wilcox, supra*, 327 U.S. at 408, 66 S.Ct. at 549.

Sections 22(a) I.R.C. 1939 and 61(a)(7), I.R.C. 1954 establish no federal law of borrowing: an amount is classed as income or loan under these sections depending upon whether or not it is received subject to an obligation under applicable state law to return it. The truth of this principle is readily established. For example, since borrowed funds are not income, the release of the obligation to repay is income, at least to the extent of the increased net worth of the debtor. See Section 61(a)(12), I.R.C. 1954; Treasury Regulations, § 1.61-12. See, also, *Wiese v. Commissioner* (C.A. 8, 1938), 93 F.2d 921, cert. den. 304 U.S. 562, where the stockholder's withdrawals became income only *after* the account receivable on the Company's books was cancelled, *not* when the withdrawals were made.

But what is the nature of the obligation that must be released before the proceeds of the borrowing become taxable income? In *Commissioner v. Jacobson* (1949), 336 U.S. 28, 31, 69 S.Ct. 358, 360, the obligations in question were "leasehold bonds" issued by an individual under Illinois law. As long as these bonds were enforceable against the individual taxpayer, the bond proceeds were not taxable; but as soon as they were surrendered for less than face, the amount of the obligation forgiven became

income. And, see, *Helvering v. American Chicle Co.* (1934), 291 U.S. 426, 54 S.Ct. 460. An exceptional illustration of this principle can be found in *Securities Co. v. United States* (S.D.N.Y. 1948), 85 F. Supp. 532; there the face amount of three promissory notes became taxable income to the maker when the New York statute of limitations ran and the notes became unenforceable under *state* law.

Another example of this rule is found in the area of deductions for losses from bad debts under Sections 23(k), I.R.C. 1939, or 166, I.R.C. 1954. There, as in the cases of Sections 22(a) and 61(a)(7), we find no "express language making its operation dependent upon state law" (Op. 5), yet the Commissioner has frequently been successful in denying a deduction for a bad debt because no valid debt had been created under *state* law. *Julius G. Day* (1940), 42 B.T.A. 109, 111, aff'd per curiam (C.A. 2, 1941) 121 F.2d 856. And, see, *Putnam v. Commissioner* (1956), 352 U.S. 82, 85, 77 S.Ct. 175, 176 (footnote 8), where the Supreme Court looked to the law of Iowa before it determined the nature of an Iowa guarantor's loss under the federal income tax law.

And, finally, we find that this Court itself has held that the concept of "theft" in Section 23(e)(3), I.R.C. 1939 (and presumably also under Section 165(c), I.R.C. 1954) is defined by *state* law although that section "contains no express language making its operation dependent upon state law." *Vincent v. Commissioner* (C.A. 9, 1955), 219 F.2d 228, 230.

Accordingly, the legal premise on which the decision of this Court is based was without foundation. If the Court meant to imply that the Nevada decree was not binding because it established a legal obligation to repay only at the time of death and not at the time of withdrawal (Op. 5), then the injustice done petitioners is just as great:

the Nevada Court could not have held the entry of the probate decree would cause a legal obligation to repay to arise where none had previously existed. The binding effect of the existence of the legal obligation under Nevada law to repay relates as well to the date of withdrawal as it does to the date of the entry of the decree.

To summarize our position on this petition for rehearing, we find the following unfortunate situation to exist:

First, the Tax Court below assumed, correctly as the foregoing authorities show, that taxable income could be imputed to the Chisms only if they were not bound under Nevada law to repay the amounts received. This conclusion is shown by the examination made by the Tax Court of all of the steps that were taken, or not taken, by the parties to establish a valid debtor-creditor relationship under the laws of Nevada, such as the making of book entries, the failure to take a note, and the failure to secure it by collateral (R. 173-174).

Second, the Tax Court below believed itself free to weigh the facts of what the parties had done under Nevada law despite a prior decree of a Nevada probate court on this very question of whether or not a binding legal obligation to repay had been created. The Tax Court felt itself free to make such an inquiry because the probate decree had been entered "in a nonadversary proceeding" (R. 186).

Third, this Court has held, and we believe correctly, that "(t)he Nevada probate court adjudication established that the Chisms had a legal obligation to repay the withdrawals that had been made." (Op. 5). Accordingly, the Tax Court below was in error in not believing itself bound by the prior Nevada court decree on the proper interpretation of Nevada law.

Fourth, but this Court then stated that the Tax Court below was correct in disregarding the Nevada probate

court decree because the existence of a legal obligation under Nevada law to repay is not controlling on whether or not income has been received for federal purposes (Op. 4-5). In other words, the Tax Court below was correct, but for the wrong reason: the question was not whether or not the Chisms had an obligation to repay the money under Nevada law, but whether or not they had such an obligation under federal law.

Rehearing under these circumstances should be a matter of right. Neither party to this case at trial or on appeal argued any such contention; respondent strove mightily to sustain the Tax Court's decision, but on the ground that the Tax Court itself had placed it, namely, that the decree was valueless because it was "nonadversary" (Res. Br. 19-23). That being true, petitioners are faced with the intolerable circumstance of having their appeal denied upon newly conceived grounds upon which they have never had their day in Court. That these newly conceived grounds for denying their appeal are suspect ought to be self-evident since neither experienced government or private counsel nor the learned trial judge below thought to argue or rely on them.

CONCLUSION

A rehearing should be granted.

Respectfully submitted,

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Certificate of Counsel

I, Valentine Brookes, being one of the attorneys for petitioners and the principal author of this petition for rehearing, certify that in my judgment this petition is well founded and is not interposed for delay.

Valentine Brookes

No. 18206

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

TRENNIS K. LILE,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

BRIEF FOR PETITIONER

ON PETITION FOR REVIEW
OF
SECURITIES AND EXCHANGE COMMISSION ORDER

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No. 18206

IN THE UNITED STATES COURT OF APPEALS

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TOPICAL INDEX

TABLE OF AUTHORITIES

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Respondent.

BRIEF FOR PETITIONER

JURISDICTIONAL STATEMENT

This is a petition for review filed pursuant to provisions of §25a of the Securities and Exchange Act of 1934 (15 U.S.C. 78-Y). The petitioner, Trennis K. Lile, an individual, was named as a cause of an order of revocation hereinafter discussed in proceedings which were instituted before the Securities and Exchange Commission. The proceedings were instituted pursuant to §§ 15 (b) and 15 A (1) (2) of the Securities and Exchange Act of 1934 by order of the Commission dated June 30, 1958, as amended, to determine whether to revoke the registration of J. Logan & Co. as a broker-dealer, whether to suspend or expel it from membership in the National Association of Securities Dealers, Inc., and whether the

petitioner Trennis K. Lile, among others, was a cause of any order of revocation, suspension, or expulsion, if entered. Hearings were held in Los Angeles during 1959 and 1960. The Transcript of the proceedings comprise nine volumes.

On April 28, 1961 a recommended decision was filed with the Securities and Exchange Commission by the Hearing Examiner James G. Ewell.

On July 9, 1962 the Commission issued its Findings and Opinion and on the basis of said Findings and Opinion issued order that the registration as a broker-dealer of J. Logan & Co., be revoked and that said J. Logan & Co. be expelled from membership in the National Association of Securities Dealers, Inc. and further ordering that the petitioner, Trennis K. Lile, among others, was a cause of the Commission's order. The order of the Commission was filed on July 9, 1962 but was not entered. Prior to entry of the order, to wit, on or about September 10, 1962 petitioner filed his petition for review before the United States Court of Appeals for the Ninth Circuit. This Court's jurisdiction accordingly rests upon 15 U.S.C. 78-Y.

STATEMENT OF THE CASE

This is a petition for review brought by petitioner, Trennis K. Lile, who is named as a cause of an order of revocation of the registration as a broker and dealer in securities of J. Logan & Co. and of the expulsion from the National Association of Securities

Dealers, Inc. of said J. Logan & Co. and further holding that petitioner was a cause of said order of revocation and expulsion which order was made by the Securities & Exchange Commission on July 9, 1962.

The practical effect of the Commission order is to prevent any further employment of petitioner by any licensed broker-dealer registered with the National Association of Securities Dealers throughout the United States.

The order for proceedings, as amended, alleges in substance that between October 1, 1953 and January 1, 1958, J. Logan & Co. and its officers and employees, wilfully violated the anti-fraud provisions of §17(a) of the Securities Act of 1933 and §§ 10(b) and 15(c) (1) of the Exchange Act (Tr. Vol. IX, pp. 5948 to 5954). It was alleged that the registrant and its officers and employees obtained money and other property from customers by means of misrepresentations and omissions of material facts and by engaging in a course of dealings which operated as a fraud and deceit upon said customers. The order further alleged that J. Logan & Co. and the petitioner, who was a salesman, induced trading in the accounts of customers which was excessive in number and frequency and that by means of representations to said customers induced them to place full trust and confidence in registrant and the petitioner, among others, and further to believe that they were receiving impartial advice and that the registrant and petitioner, among others, would act in the best interest of such customers in connection with the purchase and sale of securities. The order further

alleges that contrary to the best interest of said customers and in violation of the trust and confidence imposed therein, petitioner and others induced such customers to engage in an excessive number of transactions for both purchase and sale, failed to disclose the adverse interest of J. Logan & Company in such transactions when acting as dealer or principal. The order further alleges that petitioner and others made conflicting and inconsistent recommendations to various customers to stimulate transactions for both purchases and sales without disclosing that the advice given to one or more customers was inconsistent with the advice given to others.

A. The Facts of This Case As They Apply To Petitioner.

The record in this case consists of in excess of 5,000 pages of testimony. Witnesses called numbered approximately 50 and there were approximately 120 documentary exhibits admitted into evidence.

Hearings commenced on April 7, 1959 and petitioner was present during the testimony of one Olive T. Sands, one of his alleged customers (Tr. Vol. I, pp. 193-235). Petitioner was not represented by counsel at the time. He did, however, examine the witness Sands and a further witness, Paul Sands, her brother, who was not a customer (Tr. Vol. I, pp. 230-233; 247).

Petitioner was also present on April 8, 1959 when John T. Sinette, Jr., another witness, testified. He was not represented

by counsel but did question the witness briefly (Tr. Vol. I, pp. 365-368). Thereafter he did not appear nor was represented by counsel. Subsequently, to wit, on or about September 30, 1960, petitioner was notified that the hearings had been concluded and that the recommended decision of the Hearing Examiner was due on November 17, 1960. On October 4, 1960 petitioner wrote to the Securities and Exchange Commission in which he notified the Commission that he was not an attorney and was unfamiliar with Commission procedures. He further notified the Commission that J. H. Logan, President of J. H. Logan & Co. had instructed him that the hearings were only against the company and that individual salesmen such as himself would have a hearing at a later date. He further advised the Commission that his presence at the hearing was intended to be of help to Mr. Logan and he did not believe that the proceedings were intended to present charges against him as an individual (Tr. Vol. IX, pp. 6246-6248).

Petitioner immediately thereafter engaged an attorney at law, one Alexander Googoogian, of Los Angeles, California, who made a formal request to the Commission on behalf of petitioner to reopen the proceedings against petitioner for the purpose of receiving testimony in his defense or in the alternative that petitioner be granted the right to submit affidavits and evidence in support of his position which affidavits would set forth defensive matters as to the charges made against petitioner (Tr. Vol. IX, p. 6293). An answer on behalf of the Division of Trading was filed in opposition to petitioner's request to reopen the record on

November 3, 1960 (Tr. Vol. IX, p. 6297). On December 7, 1960, the Commission formally denied petitioner's request to reopen the record (Tr. Vol. IX, p. 6301).

The Hearing Examiner concluded that the evidence overwhelmingly established that J. Logan & Co., together with petitioner Lile and others, engaged in acts, practices and a course of business which would, and did, operate as a fraud and deceit upon their customers.

The Hearing Examiner determined that there was substantial evidence in the record showing that petitioner did the following:

1. Instigated a series of cross-trading transactions between two customers, namely, Reynolds and Hulbush.

2. Had engaged in excessive trading.

3. He effected several transactions without authorization for customers Sinette, Hauhart and Olive Sands.

4. He made a false statement to "customer" Paul Sands that J. Logan & Co. had a research budget of $800,000.00.

The examiner concluded that petitioner participated in the misrepresentations and "churning" activities of J. Logan & Co. and that thereby he wilfully violated the anti-fraud provisions.

The Commission sustained the findings of the Hearing Examiner and ruled that the record supported the findings as to petitioner.

The facts in the record as to these transactions are as follows:

1. Olive Sands: Olive Sands did not become a customer of J. Logan & Company and was involved in one sale of stock by

petitioner which was cancelled immediately upon her request. She at no time relied on the advice of petitioner but relied entirely on the advice of her brother Paul Sands who was not a customer of J. Logan & Company (Tr. Vol. I, pp. 194-234).

2. Paul Sands: Paul Sands was never a customer of J. Logan & Company or of petitioner. He had a discussion with petitioner with reference to the cancellation by his sister of the one transaction negotiated on her behalf by petitioner (Tr. Vol. I, pp. 241-247).

3. John T. Sinette, Jr. He was a customer of J. Logan & Company and of a salesman by the name of Wagner for a considerable period prior to any transaction with petitioner. When Wagner left J. Logan & Company his account was assigned to petitioner.

In a telephone conversation with petitioner Sinette advised petitioner that he had a number of securities which he wanted to sell and he further advised petitioner that he was uncertain about the condition of the market at that time (Tr. Vol. I, pp. 311-323). Petitioner recommended to him generally that he should invest in mutual funds. The witness stated that he agreed to let J. Logan & Company sell his listed securities and his over-the-counter securities because petitioner told him that no commissions would be charged. When his securities were sold per his instructions, he discovered that he had been charged a commission for two securities which were listed stock. Under the rules of the New York Stock Exchange commissions could not be waived. He complained of this to petitioner and through petitioner's efforts the

Commissions were absorbed by J. Logan & Company. He also questioned the fairness of the prices paid him on his over-the-counter stock. There was no evidence in the record that J. Logan & Company charged him any mark-up in excess of the customary 5% permitted by NASD. He stated that he had not been advised that J. Logan & Company was a principal in this transaction as respects his securities, all of which were, except as noted above, sold in the over-the-counter market. He did, however, receive confirmation tickets evidencing the disclosure of the fact that J. Logan & Co. had acted as principal (Tr. Vol. I, pp. 354-367).

4. Margaret Hulbush: Mrs. Hulbush was a real estate broker. Petitioner made several purchases and sales for her between December 26, 1956 and July 10, 1957. The Commission elicited testimony to the effect that on December 26, 1956 there was a purchase of certain stock and a sale of other stock. Then on July 10, 1957, there was another purchase of certain stock and a sale of other stock. There was no discussion between petitioner and Mrs. Hulbush as to what transaction, if any, he had negotiated with other customers respecting the same securities involved in these transactions (Tr. Vol. V, pp. 3143-3153).

5. Jean Reynolds: She testified that she had holdings of the value of approximately $57,000.00 when she first discussed her securities business with petitioner in 1956. For a period of a little over a year petitioner handled her account. During December, 1956 petitioner recommenced that she sell certain shares of stock and purchase with the proceeds therefrom other

shares of stock. Thereafter on July 7, 1957 petitioner recommended that she again sell certain stock and purchase other stock with the proceeds. Petitioner did not disclose to her his transactions with other customers of J. Logan & Company made at the same time with respect to the same securities (Tr. Vol. VI, pp. 3268-3329).

6. Hertha Hauhart: She testified that her dealings with the J. Logan & Company were through a salesman named Sarafian. Petitioner called her on one occasion on behalf of Sarafian with respect to a proposed purchase by her of a certain security. This security was ordered on her behalf by Sarafian in the belief that she had accepted the transaction. She later denied that she had approved the transaction and it was cancelled by J. Logan & Company at no cost to her (Tr. Vol. IV, pp. 1265-1349).

During the proceedings before the Commission petitioner appeared briefly, as hereinabove noted. He was not represented by counsel at any stage of the proceedings and was laboring under the belief that the proceedings concerned J. Logan & Company exclusively. He did not grasp the significance of the proceedings insofar as he was concerned until the hearings were concluded, at which time he engaged counsel and through counsel petitioned for an opportunity to submit additional evidence and to explain the evidence heretofore introduced against him. In his motion prepared by counsel, he requested an opportunity to testify in his own behalf. Counsel for the Commission opposed the petition to reopen and the Commission formally denied the petition on December 7, 1960 (Tr. Vol. IX, pp. 6246-6301).

SPECIFICATION OF ERRORS RELIED ON

1. The findings and conclusion of the Securities and Exchange Commission that petitioner is a cause of the order of revocation of the registration as a broker and dealer in securities of J. Logan & Company, and of its expulsion from membership in the NASD is not supported by substantial evidence and is contrary to law.

2. The order of the Commission denying petitioner's leave to reopen the proceedings for the purpose of receiving testimony in his defense should be set aside in the interest of justice and petitioner afforded an opportunity to present his defense.

QUESTIONS PRESENTED

1. Whether a salesman should be found the cause of an order of revocation and as a practical matter be barred from future activity as a security salesman merely because in isolated transactions he has recommended the sale of a security to one customer and the purchase of the same security to another customer.

2. Whether a salesman can be so barred from future activity as a security salesman merely because in connection with a particular account there are 96 transactions in the period of a year and a half.

3. Whether a salesman can be so barred from future activity as a security salesman merely because there were a few

isolated instances in which customers claimed that their orders were incorrectly executed and in each instance the wishes of the customers were promptly complied with at no financial loss to the customer.

4. Whether a salesman can be so barred from future activity as a security salesman merely because of the testimony of a non-customer accusing the salesman of having made a fantastically exaggerated statement of the research activities of his company in the securities field.

5. Whether a salesman can be so barred from future activity as a security salesman merely because it has been shown that there was serious misconduct on the part of the company he was associated with and some of its officers and salesmen without a further showing of his individual participation or knowledge of the wrongdoing of the others.

ARGUMENT

I

THE FINDINGS AND CONCLUSION OF THE SECURITIES AND EXCHANGE COMMISSION NAMING PETITIONER A CAUSE OF THE ORDER OF REVOCATION IS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE AND IS CONTRARY TO LAW.

A. Petitioner Did Not Commit A Fraudulent Act In His Recommendation Of The Sale Of A Security To Customer And The Purchase Of The Same Security To Any Other Customer.

The evidence in the proceedings before the Commission disclosed that petitioner on two occasions, namely, December, 1956 and July, 1957 took inconsistent positions in connection with certain securities wherein one customer sold securities and another customer purchased the same securities (Tr. Vol. VI, pp. 3283-3286; Vol. V pp. 3144-3155). As a result of these transactions the Hearing Officer concluded that petitioner wilfully violated the anti-fraud provisions by misrepresentations in giving inconsistent recommendations to the customers solely in order to stimulate transactions for both purchases and sales (Tr. Vol. IX, pp. 6364-6366).

It is a rule of law that one who asserts fraud has the burden of proving it by clear and convincing evidence.

U.S. v. Thompson (10th Circuit), 279 F. 2d 165, 167.

Fraud cannot be founded on vague, doubtful, uncertain and inconclusive evidence or upon mere suspicion or conjecture.

U.S. v. Hancock, 133 U.S. 193, 33 L.ed. 601;

Hoffman v. Overbey, 137 U.S. 465, 34 L.ed. 754.

As was said in 24 Am. Jur. Fraud & Deceit, at page 121:

> "No issue, whether it is one of fraud * * * * or of other fact, may be decided or determined upon evidence which is speculative or inconclusive."

The attorney for the Division of Trading conceded that the evidence he was offering during the proceedings as to violation of the anti-fraud provisions of the Exchange Act by petitioner and others was inconclusive, except for its cumulative effect. He said as to the inconsistent recommendations of buying and selling:

> "If this happened once or twice or ten times it probably would be meaningless. We are offering it for its cumulative effect." (Tr. Vol. VII, p. 4271).

As to petitioner there were only two instances proven and by his own standards, this evidence against petitioner is meaningless. There is no evidence in the record that petitioner in the two instances, did not act in the best interests of the particular customer involved. There was nothing in the record that showed an ulterior motive in the conduct of petitioner with respect to both the Reynolds and Hulbush transactions. Absent evidence showing

fraudulent design and purpose or a motive of profit on the part of petitioner regardless of his fiduciary obligation to these customers, the Commission and the Hearing Examiner had no reasonable basis for an inference of wrong-doing.

It is very easy for the Commission to argue that the record substantiates an abundance of wrong-doing on the part of J. Logan & Co. and at the same time make use of this testimony of divers activities to implicate petitioner and to ascribe to him evil motives. But this is not fair play as against petitioner. Nor can we say that it necessarily follows that because there was active misrepresentation of others in the company that petitioner's activities should necessarily be given the same inference of wrong-doing as ascribed to others.

As a matter of fact the S. E. C. has been cautioned in decisions of the courts not to take such a wholesale, unguarded and all encompassing criterion of wrong in its efforts to deal with so-called "boiler room" operations of security dealers. As recently as 1961, the Second Circuit Court of Appeals in Berko v. S. E. C. 297 F. 2d 116, remanded an order of the S. E. C. finding a salesman a cause of revocation of a broker-dealer registration because the Commission had acted without adequate basis in its finding as to the particular salesman. Petitioner in the instant case was not a director of the brokerage firm or a principal or an officer in authority. He was simply a salesman hired to do a job. His case had to be judged on its own merits and restraint was required on the part of the zealous representatives of the Commission to guard against unfair and

hurtful accusations without adequate reasons therefor. Berko v. S. E. C., supra, was a petition to review an order of the S. E. C. finding petitioner a cause of revocation of broker-dealer registration. The Court of Appeals held that the revocation order based on the ground that the petitioner, without adequate basis, predicted to customers that certain stock would rise in value, lacked sufficient clarity to enable the court to make a considered judgment without substituting its own findings. The case was thereupon remanded for further consideration by the Commission. Said the court at page 117:

> "We applaud the efforts of the Commission in seeking better means of dealing with 'boiler room' operations and agree fully with the thrust of the last quoted statement. This statement would appear to be sufficient to condemn a brokerage firm or those in control.
>
> "The present case, however, involves the liability of an employee of the firm who exercised no control over its operations and apparently did not engage in a continuous course of fraudulent conduct."

The Court of Appeals was faced with the same problem as in the Berko case in Kahn v. S. E. C., 2nd Circuit, 297 F. 2d 112, where it again remanded to the Commission for further hearings where the Commission found a salesman a cause of revocation of a broker-dealer license. Here, too, the Court of Appeals said that

the so-called wrong-doing of the salesman would have to be spelled out with clarity and particularity and could not be predicated on a course of practice adopted by and subscribed to by the brokerage firm hiring the salesman or those in control.

An examination of the record in the instant case will compel the conclusion that petitioner was found a cause without full and complete examination of the facts. Indeed, the Commission did not feel it necessary in the case of customer Reynolds and Hulbush, to go beyond the fact that one customer sold and one customer bought about the same time and the same stock and the fact that this was not disclosed to the individual customer.

There was no showing by the Commission that it is the practice of the Trade to discuss with one customer the activity of another. There was no showing that the advice was not given in the best interest of either or both customers.

Different customers have inconsistent investment objectives and inconsistent needs.

Fraud could readily have been proven had the Commission shown that petitioner had represented a specific fact to one customer and at the same time represented to another customer that the same fact was not true. But this test was not met.

A stock can be a good investment for one customer and a poor one for another.

Transactions are often motivated by cash needs, income tax objectives, need for balancing portfolios and desire to switch to specific securities, all of which are personal and strictly

confidential to the customer and which the customer does not wish to have publicized to third parties.

In sum, as respects petitioner's dealings with customers Reynolds and Hulbush it cannot be said that there is substantial evidence in the record rebutting the presumption that petitioner Lile used his judgment as to each transaction in consideration for the needs of each customer and that in his dealings with Reynolds and Hulbush he was motivated by an honest intention on his part to carry out the particular needs of the customer. A finding of fraud in his dealings with Reynolds and Hulbush is clearly an unwarranted inference on the part of the Commission.

B. The Record Does Not Show That Petitioner Actively Engaged In A Practice of "Churning" Accounts Allegedly Practiced By J. Logan & Co.

The Hearing Examiner and the Commission both agreed from an examination of the record that petitioner was guilty of joining in an accepted practice by J. Logan & Co. of "churning" of accounts and of excessive trading.

Of all the customers whom petitioner serviced during the period he was a salesman of J. Logan & Co., he is held in the record to have excessively traded only the account of customer Reynolds.

On this issue of excessive trading the Commission offered the testimony of Thomas Kelly, an employee of the S. E. C. He

testified that he examined the security ledger of J. Logan & Co. for the period from 1953 to 1957 and that as a result of his findings he compiled a record which was introduced in evidence as Division's Exhibit 98 (Tr. Vol. VII, pp. 4263-4266.

Witness Kelly admitted he made only a spot check and testified as follows:

> "I went through the security ledger and as I saw them I listed some down and when I thought I had enough I stopped." (Tr. Vol. VII, p. 4263).

Under examination by the Hearing Examiner the following colloquy ensued:

> "Examiner Ewell: One other question. Your exhibit or your compilation is not related particularly to any specific period except that it is within the over all period.
>
> "The Witness: That is right, yes.
>
> "Examiner Ewell: -- covered by the Commission's order to proceed.
>
> "The Witness: Yes, sir.
>
> "Examiner Ewell: October 1, '53 to January 1, '58, I think it is.
>
> "The Witness: Yes, it is. The latest transaction in here is in '57.
>
> "Examiner Ewell: Let me ask you this. You skipped around and what you attempted to do was to

put down transactions which appeared to you to be worthy of compilation in this exhibit.

"The Witness: That is correct. I just took certain ledgers, and I just looked down through the ledger through the page and where I saw two trades on or about the same date, one a buy and one a sell, both were customers; then I jotted them down on here. I have the actual letters that I looked at in the security ledgers."

When the witness was asked as to whether or not he made any further investigations as to whether or not the firm was maintaining a position in the securities which he put down in the exhibit he answered that he did not. He merely looked down the page and when he saw a trade-in and trade-out between customers he paid no attention as to whether or not there was a position in the stock (Tr. Vol. VII, p. 4288).

A finding of fraud as against petitioner must be supported by substantial evidence in the record and cannot be based upon inferences of the activities of others.

C. The Evidence Presented By Witnesses Olive Sands, Paul Sands, John T. Sinette, Jr. And Hertha Hauhart Does Not Justify His Being Named A Cause In The Revocation Proceedings Against J. Logan & Co.

As hereinabove noted the record in this case encompasses 8 volumes of testimony. Miss Reynolds and Miss Hulbush testified that petitioner actively handled their accounts and guided their investment activities over an extended period. The other witnesses against petitioner testified to at best only incidental contacts with petitioner.

Olive Sands never became a customer of petitioner and she stated for the record that her brother Paul Sands was her security advisor (Tr. Vol. I, pp. 195-199).

After several discussions over a period of a month, petitioner persuaded her to sell certain stock she held and to purchase other stock.

When she consulted with her brother and he advised her to refuse the stock allegedly purchased, she demanded and received an immediate cancellation of the order. She objected, however, to a $60.00 charge which petitioner informed her was a cashiering charge because he had to buy back the stock for her that had been sold (Tr. Vol. I, pp. 199-212, 232). The most that could be said of her testimony is that there had been a misunderstanding and it had been resolved entirely to her satisfaction without loss, pecuniary or otherwise, to her.

The witness, Paul Sands, her brother, never was a customer of petitioner and never intended to purchase or sell any stock through petitioner. He merely inquired of the transaction had with his sister. He was an obviously biased witness. It is on his unsubstantiated testimony that petitioner claimed an $800,000.00 research budget of J. Logan & Co. which the Commission sought fit to ascribe as a fraudulent misrepresentation by petitioner to a customer. The witness admitted on cross-examination that he had trouble with his hearing and was somewhat confused as to the statement allegedly made by petitioner Lile (Tr. Vol. I, pp. 241-249).

The witness John T. Sinette, Jr.'s testimony discloses that he had been a customer of J. Logan & Co. long before he had been contacted by petitioner, having had many dealings with a salesman named Wagner. The witness Sinette himself desired to sell certain securities held by him and, in fact, personally initiated a sales transaction made on his behalf by petitioner. The witness testified that he was not imposed upon by petitioner or anyone else, that he was well versed in the affairs of the market, that he subscribed to Barron's and the Wall Street Journal. His only complaint was the prices he paid for the stock which was sold for him. (Most of this stock was over-the-counter stock, except for two listed securities.) He did receive confirmations of his sales disclosing J. Logan & Co. as a principal. The commissions paid were reinbursed him to placate him (Tr. Vol. I, pp. 311-354).

The witness testified at page 367:

"I understood that there would be no charge for

the sale. Now, my knowledge was rather limited I must admit."

He further stated on page 369:

"* * * I did not feel that I could definitely prove I had been taken advantage of."

A broker-dealer cannot be held guilty of "churning" an account where the transactions are initiated by the customer.

Carr v. Warner, 137 Fed. Supp. 615.

The Commission does not deny that petitioner was a salesman and not a maker of policy in the company. There is no evidence that petitioner knew what other people were doing in the company. It was incumbent upon the Commission to show that petitioner's dealings with his customers resulted in excessive trading and so-called "churning" and the testimony by the witness Kelly did not fulfill this burden. Where one's motive or intent is at issue events of a similar nature must be by the party charged with the Commission of the particular act in order to be competent evidence. Certainly acts of other parties is not admissible without a showing of a conspiracy which was not pleaded or proved in this case.

20 Am. Jur. p. 278, Evidence, §302.

There is a complete absence of evidence to rebut the presumption of good faith and fair dealing on the part of petitioner in the trading activity he conducted for his customer Jean Reynolds.

The court in S. E. C. v. Capital Gains Research Bureau, Inc., (2d Circuit) 300 F. 2d 745, stated that each case must be judged

upon its particular facts after a full and fair hearing and not upon unwarranted inferences.

Justice Clark, Circuit Judge, in his concurring opinion for remand in both the Kahn and Berko cases, supra, points out at 297 F. 2d, page 115, that the Commission cannot solely rely on the so-called "shingle" theory of implied fair dealing (which theory is set out in Hughes v. S. E. C. (2d Circuit), 139 F. 2d 434, cert. den. 321 U. S. 786) when it condemns the "boiler room" activities of a securities company, but the Commission must go further and connect a salesman explicitly with such activities. The record in the instant case is replete with generalities and offers myriad instances of suggested wrongdoing by others with no connection whatsoever of petitioner directly with the alleged fraudulent practices.

In their appraisal of the testimony given by witness Hauhart against petitioner, the Commission and the Hearing Examiner both concluded that there had been fraudulent activity on the part of petitioner. The record shows that she was also the regular customer of another salesman named Sarafian who had been named as a cause in the order of revocation. Petitioner's alleged connection with her involved his calling her on behalf of Sarafian with reference to the purchase by her of certain stock. She agreed to the purchase and subsequently received a confirmation of same. When asked about the purchase which she felt had been pressured upon her she stated as follows:

"And what did you say to that?

"Well I think I just accepted it." (Tr. Vol. IV, p. 1300)

Under cross-examination the witness admitted that she had dealt in grain speculation for several years and admitted that where there had been previous misunderstanding she had cancelled an order at no cost to herself and was well able to cancel the order allegedly placed for her by petitioner (Tr. Vol. IV, p. 1323). The following is noteworthy:

> "Q. Mrs. Hauhart, you cancelled the transaction, the second one that you had with the firm, did you not?
>
> "A. Yes.
>
> "Q. And you didn't ask for a cancellation on the other transactions, yet knowing that you could do so if you wanted to.
>
> "A. I was taken too much by surprise. * * *"

The testimony of the foregoing witness, it is submitted, fails to meet the test of substantiality such as to justify the deprivation by petitioner of his good name and of his right to livelihood in the securities field, on the charge of making unauthorized sales, for this transaction was obviously ratified.

CONCLUSION

Petitioner has been found guilty of serious charges of fraud on evidence which is speculative and unsubstantial. The penalty imposed upon petitioner is without question unwarranted by the evidence and should be set aside.

There was no proof in the proceedings showing fraudulent conduct participated in by petitioner. Absent such proof, there is nothing to indicate in this record that petitioner intended anything but maximum profits for his client and prospective client.

The findings and conclusions of the S. E. C. as to petitioner, it is respectfully urged, should be set aside; or, in the alternative, the proceedings should be remanded to the Commission to take further evidence and thereby to permit petitioner to present testimony in his defense.

Respectfully submitted,

FIZZOLIO & FIZZOLIO and
ALBERT VIERI

By /s/ James M. Fizzolio
JAMES M. FIZZOLIO

CERTIFICATE

I certify that in connection with the preparation of this brief I have examined Rules 18 and 19 of the United States Court of Appeals For The Ninth Circuit and that in my opinion this brief is in full compliance with those Rules.

/s/ James M. Fizzolio
JAMES M. FIZZOLIO

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 18,206

TRENNIS K. LILE,

Petitioner

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent

Petition for Review of Order of the
Securities and Exchange Commission

BRIEF FOR THE RESPONDENT

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I N D E X

Page

C I T A T I O N S

Cases:

Page

Cases: (continued)

Page

Cases: (continued)

Page

Cases: (continued)

Statutes and Rules:

Page

Statutes and Rules: (continued)

IN THE UNITED STATES COURT OF APPEALS

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SECURITIES AND EXCHANGE COMMISSION,

Respondent

NATURE OF THE PROCEEDING

Petitioner, Trennis K. Lile, is seeking review pursuant to Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a), of an order of the Securities and Exchange Commission entered under Sections 15(b) and 15A of the Act, 15 U.S.C. 78o(b) and 78o-3. The Commission's order (R. 6455) [1/] revoked the registration of J. Logan & Co. ("the company") as a broker and dealer in securities, expelled the company from membership in the National Association of Securities Dealers, Inc., and found that certain persons, including petitioner who was a salesman for the company, were each a cause of the revocation and expulsion. In its Findings and Opinion (R. 6441-6454) the Commission

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1/ "R.___" refers to the record on review, and "Br.___" refers to petitioner's brief.

held that the company, together with or aided and abetted by certain of its officers and salesmen, had willfully violated the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), of Sections 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and 78o(c)(1), and of Rules 10b-5 and 15c1-2 thereunder, 17 CFR 240.10b-5 and 240.15c1-2. Petitioner seeks to have this Court set aside the Commission's order as to him [2/] or, in the alternative, to remand the case to the Commission for the taking of additional evidence in his defense.

COMMISSION'S MOTION TO DISMISS PETITION FOR REVIEW

When the petition for review was filed in this Court, the Commission moved to dismiss it on the grounds (1) that this Court lacks jurisdiction because petitioner did not file the petition within the statutory 60-day filing period and (2) that petitioner, by his failure to file exceptions to the hearing examiner's recommended decision, did not exhaust his administrative remedies. Following argument on the Commission's motion before a panel consisting of Judges Chambers, Pope and Barnes and the subsequent filing of supplemental briefs at the Court's request, the Court on January 31, 1963, ordered that further consideration of the Commission's motion be postponed until the argument and submission of the case on the merits.

2/ A petition for review filed by another person who was named as a cause in the Commission's order is pending before this Court in Hersh v. Securities and Exchange Commission, No. 18,190.

Although the Commission still urges that the petition for review be dismissed, we will not repeat in this brief our arguments in support of the motion to dismiss. Instead, we refer the Court to our Memorandum of Points and Authorities in Support of Respondent's Motion to Dismiss Petition for Review and to our Supplemental Memorandum in Support of Motion to Dismiss Petition for Review.

STATUTES AND RULES INVOLVED

[This section, except for the final paragraph, is identical to the corresponding section of our brief in Hersh v. Securities and Exchange Commission, No. 18,190, filed herewith.]

Pertinent provisions of the relevant statutes and rules thereunder are set forth in the Appendix hereto (pp. la et seq., infra).

The Securities Exchange Act of 1934, as part of federal legislation for the protection of investors, was enacted, as set forth in its preamble:

> "To provide for the regulation of securities exchanges and of over-the-counter markets . . . [and] to prevent inequitable and unfair practices on such exchanges and markets. . . ."

To carry out this purpose, the Act provides a comprehensive scheme of registration and regulation of national securities exchanges and their members as well as for the registration and regulation of brokers and dealers doing business through interstate media otherwise than on a national securities exchange, i.e., the so-called over-the-counter market.

Section 15(a) of the Act prohibits any broker or dealer from using the mails or any means or instrumentalities of interstate commerce to effect transactions in securities without prior registration with the Commission pursuant to Section 15(b) of the Act (except for certain exemptions not involved here).

Section 15(b) requires the denial or revocation of such registration if the Commission finds, after notice and opportunity for hearing, that such denial or revocation is in the public interest and that a broker or dealer, or a person controlled by it, has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, or rules thereunder. 3/

Section 15A of the Securities Exchange Act provides for cooperative self-regulation of the over-the-counter securities industry through registration with the Commission of national securities associations composed of brokers and dealers in securities. The National Association of Securities Dealers, Inc.,is thus far the only association registered under Section 15A. Section 15A(1)(2) authorizes the Commission, after notice and opportunity for hearing, to expel from a registered securities association any member thereof who the Commission finds has violated any provision of the Securities Act, the Securities Exchange Act, or rules thereunder, if such action appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors or to carry out the

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3/ This Court reviewed an order denying registration under Section 15(b) in Pierce v. Securities and Exchange Commission, 239 F. 2d 160 (1956).

purposes of Section 15A.[4/]

Both the Securities Act and the Securities Exchange Act contain specific antifraud provisions. Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, as implemented by Rule 10b-5 under the latter provision, make unlawful the use of the mails or interstate facilities by any person in connection with the offer or sale of any security by means of a device, scheme or artifice to defraud, an untrue or misleading statement of a material fact, any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, or by means of any other manipulative or deceptive device. Section 15(c)(1) of the Securities Exchange Act specifically prohibits such conduct by brokers or dealers and authorizes the Commission, by regulations, to define such devices as are manipulative, deceptive, or otherwise fraudulent.

Section 15A(b)(4) of the Securities Exchange Act, pursuant to which the finding was made that petitioner was a "cause" of the order of revocation and expulsion, operates to prevent any broker or dealer who employs such a

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4/ Under Section 15A(b)(8) such an association may also expel or otherwise discipline its members. In Samuel B. Franklin & Co. v. Securities and Exchange Commission, 290 F. 2d 719 (1961), certiorari denied, 368 U.S. 889 (1961), this Court reviewed an order of the Commission affirming disciplinary action by the National Association of Securities Dealers against one of its members.

person from being admitted to or continued in membership in the National Association of Securities Dealers, Inc., or any other such registered association, unless the Commission otherwise gives its approval or direction in cases where it is deemed appropriate in the public interest. 5/

Section 25(a) of the Act, which grants jurisdiction to the Courts of Appeals to review Commission orders, provides that the Commission's findings of fact shall be conclusive if supported by substantial evidence.

This section also authorizes the Court, on application by either party, to order additional evidence to be taken before the Commission upon a showing to the satisfaction of the Court that such additional evidence is material and that there were reasonable grounds for failure to adduce it in the hearing before the Commission.

QUESTIONS PRESENTED

1. Whether the Commission's finding that petitioner willfully

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/ Although the finding that petitioner was a "cause" of the revocation and expulsion operates only to preclude his employment by a member of a registered securities association, the Commission's finding that he willfully violated the antifraud provisions may affect his right to employment with any registered broker-dealer, including those who are not members of a registered securities association. See Section 15(b) of the Securities Exchange Act, supra.

violated the antifraud provisions of the Securities Act and the Securities Exchange Act is supported by substantial evidence.

2. Whether petitioner has failed to show that there were reasonable grounds for his failure to adduce additional evidence in the hearing before the Commission.

STATEMENT OF THE CASE

The Commission found that J. Logan & Co., together with or aided and abetted by various persons including petitioner, willfully violated the antifraud provisions of the federal securities laws by inducing customers who were inexperienced in securities matters to place trust and confidence in the company and its salesmen and to rely on them to act in the customers' best interests, and then engaging in acts and practices contrary to the financial welfare and investment aims of the customers in order to generate income for themselves. In violation of the trust and confidence of their customers, they induced excessive trading in customers' accounts, advised customers to sell securities while simultaneously advising other customers to purchase the same securities, effected transactions without prior authorization, and made various misrepresentations.

The Company's Method of Operation

A description of the method of operation employed by J. Logan & Co. is essential to a proper understanding and appraisal of the significance of the part played by Lile in the overall enterprise. For the convenience of the Court, we will summarize those aspects of the company's method of

operation that are pertinent to the issues raised on this appeal. A more detailed description can be found in the Commission's Findings and Opinion (R. 6441-6454).[6/]

The company's policy was to maintain a large sales force, consisting of men with no prior experience in the securities business who concentrated on telephone solicitation of unknown persons. Novice salesmen were given a portion of a local street number telephone directory from which each man was instructed to call if possible 100 to 125 numbers per day. The salesmen were told that in view of their lack of experience, they would be less likely to demonstrate their ignorance in telephone calls.

In their sales solicitations, the salesmen placed great emphasis on the company's so-called extensive and highly-skilled research department, although in fact the company maintained no research department worthy of the name.[7/]

Through the technique of indiscriminate telephone calls, the company obtained a clientele of impressionable, naive, and unsophisticated investors who thereafter were urged to place their trust and confidence in the

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6/ With one possible exception (see p. 36, infra) petitioner does not challenge the Commission's findings concerning the company's method of operation. Accordingly, we have in general omitted record references in describing the company's business.

7/ For a description of the limited research facilities that the company actually had, see footnote 2 of the Commission's Findings and Opinion (R. 6443).

salesmen and to rely on them to act in the customers' best interests. Taking advantage of the trust and confidence thus induced, and in complete disregard of the financial welfare of the customers, the company and its salesmen followed a practice designed to achieve a large volume of trading, without consideration of the quality of the securities involved or the needs of the investors, and frequently resulting in substantial losses to the customers. 8/

Various techniques and practices were employed to achieve this objective:

Salesmen were organized into groups or teams, and competition among such groups as well as among individual salesmen was fostered by bulletins listing the relative standings of the salesmen and the groups, and by occasional awarding of cash prizes to those making the best showings in sales.

8/ As a former salesman testified: "Over and over again we were told as part of the indoctrination at J. Logan & Company that the only reason we were there was to make money, and we were told more often than we were told to the contrary that it didn't make any difference whether we made money for the customers or not. Our job was to make money for ourselves . . . . [T]he emphasis was on making money through trading and selling no matter what we sold rather than on selling a good stock. . . ." (R. 3604, 3606). Another salesman testified they were told "that securities should be traded as often as necessary in order for the obvious reason of more commissions resulting from this" (R. 687).

Salesmen frequently were successful in obtaining a list or even physical possession of securities already held by new customers. Such customers were invariably advised that all of their holdings were unsuitable for them and that they should liquidate their entire portfolios, including high grade investment securities, and invest in other securities, frequently of a highly speculative nature, recommended by the salesmen.[9/] Thereafter customers were persuaded to make frequent additional purchases, either through the investment of other funds or through the liquidation of securities previously acquired on the recommendations of the salesmen. In some instances the same security was bought and sold numerous times in the account of a single customer, all on the recommendation of one or another salesman.

When, as frequently happened, a salesman left the firm, the customers' account cards of the departing salesman were distributed among remaining salesmen, who were instructed to call the customers immediately and, by convincing them to sell the securities in their portfolios and reinvest in other securities, persuade them to remain as clients of the firm rather than of the former salesman. This was accomplished by pointing out the errors and bad judgment of the former salesman or by implying that he had been fired for improper conduct or had left under a cloud. The

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9/ The salesmen were advised by the company of "the advantages of certain types of securities and the ease with which they are sold to clientele, the more speculative securities as an example" (R. 691).

salesmen were instructed to use "fair means or foul" to make certain that the former salesman did not take his accounts away with him. On one occasion cash prizes were given to the salesmen who were most successful in weaning away the customers of a former salesman by persuading such customers to reinvest in other securities.

Still other techniques used to induce excessive trading in customers' accounts were the practice of effecting transactions without the customer's prior authorization or without prior consultation with the customer and the practice of simultaneously recommending the purchase of a security to one customer while persuading another to sell the same security, without disclosing the contradictory recommendations to either customer. This "switching" or cross-trading of securities back and forth between customers provided a fruitful source of mark-up income without incurring the risk and expense of maintaining inventories.

Petitioner's Activities as a Salesman for the Company

The record shows that petitioner was an active participant in the company's fraudulent scheme. The testimony relates to his dealings with customers Olive Sands, Jean Reynolds, Margo Hulbush, John T. Sinette, Jr., and Hertha Hauhart.

Olive Sands: Miss Sands received a telephone call from Lile in April 1958 (R. 193-94). At that time she owned stock which she had inherited from her father (R. 195, 236-37). She had no experience in trading in securities, had engaged in only one securities transaction in the preceding three or four years, had never worked for a living (she had been

with her father until his death), and always depended on the advice of her brother (R. 209, 236-37). After inquiring whether she owned any securities, Lile recommended that she sell the stock that she owned and purchase another security; he told her that the change would be to her advantage (R. 195). She replied that she knew nothing about stocks and would not change her investment without consulting her brother (R. 196). When she later informed Lile that her brother had advised her not to make the change (R. 204), Lile urged her to disregard her brother's advice and emphasized that the transactions would be profitable for her (R. 205). Although she at no time agreed to the recommended change (R. 204, 211), Lile nevertheless effected the transactions without her knowledge and then sent her the confirmation slips for the sale and purchase (R. 205, 207, 233, 5000, 5002). Thereafter, in an attempt to induce her to approve the unauthorized transactions, Lile again urged her to disregard her brother's advice and told her that her brother would not oppose the transactions if he had her interests at heart (R. 209, 222). When Lile then stated that she would have to pay a $60 fee if she rejected the transactions, she told him to telephone her brother (R. 227-28). Still attempting to obtain approval of the transactions, Lile called her brother, asked him why he would not agree to the transactions, and said that he (the brother) knew nothing about stocks and that J. Logan & Co. had an $800,000 research budget

and was well-informed (R. 242-44, 248).[10/] Subsequently Lile cancelled the transactions (R. 228, 237-38).

Jean Reynolds and Margo Hulbush: These customers will be considered together, since their accounts were subjected to a series of cross-trading transactions.

When Lile first telephoned Mrs. Reynolds in 1956, she owned shares of stock in several well-known companies (R. 3269, 3271). Her only prior dealings with a brokerage firm had been the transaction approximately four to five years earlier in which she had purchased those shares with funds that she had received as a gift from her father (R. 3278). She visited Lile at his office, and in response to his inquiry she disclosed her securities holdings (R. 3269-70, 3289), whereupon Lile recommended that she sell her securities and purchase others (R. 3273). In less than two months' time — from August 31, 1956,to October 26, 1956 — all her securities were sold for $56,668 (R. 3273, 3310-11, 5247-54), and during the entire period of 14 months that she had an account with J. Logan & Co. a total of 96 transactions were effected in her account, all of them upon Lile's recommendation (R. 3275, 3319-20). Lile's explanation to her as to how he was earning income from handling her account was that if she made money he would

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10/ Petitioner's assertion (Br. 21) that Miss Sands' brother was "somewhat confused" about the misrepresentation concerning the research budget is contrary to the evidence. Mr. Sands repeatedly testified, both on direct and cross-examination, that he was certain about the figure of $800,000 for research (R. 244, 246-47). He also testified that although he had some difficulty with his hearing, he could hear better over the telephone than in person (R. 247).

also make money (R. 3287). She advised Lile on many occasions that she did not understand her account, but Lile replied that he was handling it for her and assured her that she should not worry, that it was his job to worry about the account (R. 3288).[11/]

Mrs. Margo Hulbush started doing business with Lile in the fall of 1956 (R. 3144). At the very beginning she told him that she did not have the funds necessary to be a trader or to engage in speculative transactions (R. 3152).

Lile induced a series of four "switches" of securities between the Reynolds and Hulbush accounts. Two of the switches occurred on December 26, 1956, and the remaining two occurred on July 10, 1957, as

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11/ On cross-examination Mrs. Reynolds was questioned about one of the securities that she purchased on Lile's recommendation (R. 3324-25):

"Q. Did you know it was speculation at the time you bought it?

"A. No, I didn't know.

"Q. What would you have expected it to be when you buy a stock that sells for around forty or fifty cents a share, would you expect it to be a high-grade —

* * *

"A. Well, I would assume it was. I was under the impression that I was going to have what I had left saved."

follows:

(1) December 26, 1956 - 100 shares of Landers, Frary & Clark

Sold by Reynolds at 17-3/4

Bought by Hulbush at 19-1/4

(2) December 26, 1956 - 100 shares of Aircraft Radio Corp.

Sold by Hulbush at 18-3/4

Bought by Reynolds at 20-1/8

(3) July 10, 1957 - 50 shares of Dravo Corp.

Sold by Reynolds at 68

Bought by Hulbush at 73

(4) July 10, 1957 - 50 shares of Belmont Iron Works

Sold by Hulbush at 41-1/2

Bought by Reynolds at 45-1/8

All these transactions were confirmed by the company as principal rather than as agent for either customer; i.e., the company purchased the security from one customer and resold it to the other customer, taking the difference between the buying and the selling prices as its profit. All these purchases and sales were made upon Lile's recommendation without disclosure to either customer that he was making contrary recommendations to the other, and in at least three of the four transactions the securities that were sold had originally been acquired by the customers upon Lile's recommendation (R. 3145-60, 3275-87, 5238-41, 5255-59). In their dealings with Lile, these customers were advised by him that his recommendations were designed to bring them a better profit or to prevent a loss (R. 3148, 3156, 3308).

John T. Sinette, Jr.: This customer started trading with J. Logan & Co. following a telephone call in May 1957 from a salesman named Wagner (R. 308-09). Sinette, who was 49 years old at the time of the hearing, had engaged in about twelve securities transactions in his entire lifetime (R. 310). He did not know the difference between a principal and an agency transaction (R. 318), and although he occasionally subscribed to certain financial publications, he did not do much reading in the financial field (R. 343-44). After making two purchases through Wagner (R. 317-18), Sinette received a telephone call in January 1958 from Lile, who said that Wagner was no longer with the firm (R. 318-20). Sinette told Lile that he had been displeased with Wagner's high-pressure salesmanship and with one of the securities that Wagner had sold him (R. 320, 330-31). Lile replied that Wagner should have informed Sinette of the highly speculative nature of the security, and he apologized for Wagner's "misrepresentation" (R. 320). He then recommended that Sinette sell his securities and purchase others (R. 322). He said that he wanted to make amends for Wagner's misconduct and that in order to prove his good faith, he would effect the sales without charging the usual fees (R. 320, 323). Thereafter most of Sinette's securities were sold by Lile for $4714 (R. 326-27, 5009-16). When Sinette received the confirmations, he noticed charges for commissions on some of them (R. 334). These charges were later cancelled when Sinette complained (R. 334, 339).

Hertha Hauhart: This customer, a widow, started trading with J. Logan & Co. in January 1957 through a salesman named Sarafian (R. 1267, 1271). Although she had previously traded in the grain market for about

three years (R. 1323), she had no experience in the stock market and had never owned a security (R. 1300, 1324). Sarafian told her that it is foolish to keep money in a savings account, that he wanted to make money for her, that the company had earned millions of dollars, that it could make money only if its customers made money, that it had an extensive and competent research department, and that she should trust him and have confidence in him (R. 1268-69, 1272, 1276-77, 1291, 1296). After three transactions had been effected in her account, including an unauthorized purchase which was later cancelled when she complained, she received a telephone call in May 1957 from Lile, who told her that Sarafian was out of town (R. 1281, 1288, 1291-94, 1297). Lile urged her to buy a certain stock on the advice that an announcement would appear in the newspapers the following week and that the stock would rise thereafter (R. 1297). She did not agree to buy (R. 1298). About fifteen minutes later she telephoned the company and was connected with Sarafian, who told her that her purchase of the recommended security had been confirmed immediately (R. 1299-1300, 1353). She was so surprised at finding Sarafian in town after Lile had said that he was away that she agreed to the purchase (R. 1300, 1328-29). Subsequently, she discovered that the transaction covered warrants rather than stock (R. 1302-03, 1334-35). Lile had not told her that he was recommending warrants, and at the time of the purchase she did not even know what warrants were (R. 1302, 1330-31).

The Administrative Proceeding

The administrative proceeding here involved was instituted by the Commission on June 30, 1958. Pursuant to Rule 6(a) of the Commission's Rules of Practice, 17 CFR 201.6(a) (then Rule III(a), 22 Fed. Reg. 10442 1957)), petitioner received a copy of the order for proceedings and notice of hearing together with a letter from the Secretary of the Commission advising him that the Commission's findings in the proceeding might be binding on him and that he was entitled to participate as a party (R. 5948-4, 5962; Affdt.).[12/]

On April 7, 1959, the second day of the hearing, petitioner was present in the hearing room. The hearing examiner, after ascertaining that petitioner was not represented by counsel, advised him that he was entitled to have an attorney represent him (R. 197, 206). In response to petitioner's assertion that he thought the proceeding was not directed against him personally but only against the company, the hearing examiner pointed out that petitioner had been named in the order for proceedings and that the charges, if proved, would affect his right to future employ-

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1/ "Affdt." refers to an affidavit executed by Ernest L. Dessecker, Records and Service Officer of the Commission, and filed in this Court in support of the Commission's motion to dismiss the petition for review (see p. 2, supra).

ment (R. 206).[13] Petitioner cross-examined two of the Commission's witnesses that day and another on the following day (R. 230-34, 247, 366-68).

13/ The following colloquy occurred (R. 206):

"Hearing Examiner: You know you have a right to counsel, of course?

"Mr. Lile: Yes.

"Hearing Examiner: You know you have the right to have an attorney here to protect your interests?

"Mr. Lile: Well, I didn't know this was against me, I thought this was against J. Logan and Company.

"Hearing Examiner: You knew you were named in the Order?

"Mr. Lile: That is why I am here.

"Hearing Examiner: Then you know that could affect your interests?

"Mr. Lile: Well, it has for the past nine months.

"Hearing Examiner: It would affect your right to employment with other companies.

"Mr. Lile: Yes.

"Hearing Examiner: If the findings should be against you.

"Mr. Lile: If it is fair for that to go through and the truth comes out, fine."

The hearing was later recessed. Thereafter on September 25, 1959, petitioner was notified that the hearing would be reconvened on October 15, 1959, and he was requested to arrange to be in daily attendance (R. 6037-38). By letter of October 7, 1959, he was requested to be prepared to go forward with his defense at the reconvened hearing.[14/]

On August 31, 1960, following the close of the hearing, petitioner was notified of the scheduled dates for the filing of proposed findings and briefs, hearing examiner's recommended decision, and exceptions to the recommended decision (R. 6168-69; Affdt.). He was again notified when the Commission on October 3, 1960, extended the time for these filings (R. 6245; Affdt.). On October 11, 1960, at petitioner's request, the Commission granted a further extension, authorizing him to file proposed findings and a brief by October 24, 1960 (R. 6246-48). He did not avail himself of that extension (Affdt.). Instead, on October 28, 1960, Alexander Googooian, an attorney representing petitioner, sent a telegram to the Commission requesting either that the record be reopened for the receipt of testimony in petitioner's defense or that petitioner be granted the right to present defensive matter by way of affidavits and proposed findings. In support of this request it was asserted that at the time of the hearing James Logan, president of the company, had told petitioner that the individual salesmen such as petitioner were not involved in that proceeding and that hearings would be held at a later time with respect to them. It was further

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14/ See pp. 2608-11 of the transcript of testimony, set forth in the Appendix hereto (pp. 5a-8a, infra).

asserted that Mr. Logan, although having stated to petitioner that he would notify him of any witness who might testify concerning him, had failed to notify him of two witnesses who had so testified (R. 6293). The Commission, on December 5, 1960, ruled on petitioner's request, concluding that he had had full and adequate opportunity to present evidence in his defense and that sufficient showing had not been made to warrant reopening the record at that late date, after the extended time for the parties to file proposed findings and briefs had expired. Accordingly, the request to reopen the record or submit affidavits was denied. The Commission did, however, grant an extension of time to December 12, 1960, for petitioner to file proposed findings (R. 6300-01). Again, the filing was not made (Affdt.).

The hearing examiner's recommended decision was issued on April 28, 1961, and served on petitioner's counsel together with a copy of the Commission's Rules of Practice and a letter calling attention to the fact that Rule 17 provides for the filing within specified periods of time of written exceptions to the recommended decision and a brief in support of such exceptions (R. 6306-86; Affdt.). Although the hearing examiner found that petitioner had willfully violated the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and that he should be named a cause of any disciplinary order entered against the company (R. 6366), petitioner filed no exceptions or brief (Affdt.).

On July 9, 1962, the Commission entered the order that petitioner now seeks to have reviewed (R. 6455).

ARGUMENT

I. THE COMMISSION'S FINDING THAT PETITIONER WILLFULLY VIOLATED THE ANTIFRAUD PROVISIONS OF THE SECURITIES ACT AND THE SECURITIES EXCHANGE ACT IS SUPPORTED BY SUBSTANTIAL EVIDENCE.

The federal securities laws are the result of Congressional awareness that securities are "intricate merchandise." H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 8. Their enactment followed a Presidential message urging that there be added to the ancient rule of caveat emptor the further doctrine of "let the seller also beware." Id. at p. 2. In Archer v. Securities and Exchange Commission, 133 F. 2d 795, 803 (C.A. 8, 1943), certiorari denied, 319 U.S. 767 (1943), the court, in affirming a Commission order revoking a broker-dealer registration, stated:

> "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action. The Congress has seen fit to regulate this business. Though such regulation must be done in strict subordination to constitutional and lawful safeguards of individual rights, it is to be enforced notwithstanding the frauds to be suppressed may take on more subtle and involved forms than those in which dishonesty manifests itself in cruder and less specialized activities."

because "the securities field, by its nature, requires specialized and

unique legal treatment,"[15] broad meaning is given to the concept of fraud under the federal securities laws, and the antifraud provisions of these laws are not limited to common law concepts. Norris & Hirshberg, Inc. v. Securities and Exchange Commission, 177 F. 2d 228, 233 (C.A. D.C., 1949); Charles Hughes & Co., Inc. v. Securities and Exchange Commission, 139 F. 2d 434, 437 (C.A. 2, 1943), certiorari denied, 321 U. S. 786 (1944); Los Angeles Trust Deed & Mortgage Exchange v. Securities and Exchange Commission, 264 F. 2d 199, 210 (C.A. 9, 1959).

In applying the antifraud provisions to the activities of brokers and dealers in securities, the Commission has on numerous occasions held that a broker or dealer impliedly represents that he will deal fairly with the public.[16] In its opinion in the case of Mac Robbins & Co., Inc., Securities Exchange Act Release No. 6846, July 11, 1962, CCH Fed. Sec. L. Rep. ¶ 76,853, at 81,166, which was recently affirmed by the Court of Appeals for the Second Circuit, sub nom Berko v. Securities and Exchange Commission, 316 F. 2d 137 (1963),[17] the Commission discussed the history and application of this principle:

15/ Arleen Hughes v. Securities and Exchange Commission, 174 F. 2d 969, 975 (C.A. D.C., 1949).

16/ See 3 Loss, Securities Regulation 1482-93 (2d ed. 1961).

17/ This is not the same Berko opinion that petitioner cites (Br. 14, 15, 23), although both opinions relate to the same administrative proceeding. Petitioner cites Berko v. Securities and Exchange Commission, 297 F. 2d 116 (C.A. 2, 1961), and the companion case of Kahn v. Securities

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"Early in the administration of the federal securities laws, we held that basic to the relationship between a broker or dealer and his customers is the representation that the latter will be dealt with fairly in accordance with the standards of the profession. The failure of a broker or dealer to disclose that his conduct does not meet such standards operates as a fraud on customers. The Court [of Appeals for the Second Circuit], in a landmark case [Charles Hughes & Co., Inc. v. Securities and Exchange Commission, 139 F. 2d 434 (1943), certiorari denied, 321 U. S. 786 (1944)], recognized this so-called 'shingle' theory and affirmed our conclusion that it was not fair dealing for a broker or dealer in securities to charge customers prices unrelated to the prevailing market price. We have also applied the shingle theory in a variety of other instances. Thus, we have recognized that without appropriate disclosure

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and Exchange Commission, 297 F. 2d 112 (C.A. 2, 1961), which were petitions for review filed by two salesmen who had been named as causes of the revocation order in Mac Robbins & Co., Inc., Securities Exchange Act Release No. 6462 (Feb. 6, 1961), supplemented, Securities Exchange Act Release No. 6498 (Mar. 16, 1961). Following a remand to the Commission pursuant to the Berko and Kahn decisions reported in 297 F. 2d, the Commission issued a new opinion reaffirming its original order. Berko again petitioned for review, and the subsequent opinion of the Second Circuit affirming the Commission's order is the one that we have cited in the text.

it is a fraudulent practice to sell securities at a market price which is materially affected by artificial restrictions and stimulations caused by the seller's own activities, to sell oil royalties at prices unrelated to the reasonable value of estimated oil recoverable from the underlying tract, to execute transactions not authorized by the customer, to sell securities that are subject to a lien, to fail to execute orders or deliver securities promptly, or to accept customers' funds while insolvent." [Footnotes omitted.]

The antifraud provisions and the broker-dealer's obligation of fair dealing take on added significance and apply with special force where there is a disparity in degree of knowledge of market conditions as between the dealer and customer or where an element of trust and confidence is present. In Charles Hughes & Co., Inc. v. Securities and Exchange Commission, supra, the court noted, 139 F. 2d at 437, that "the essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do," and stated:

"Even considering petitioner as a principal in a simple vendor-purchaser transaction . . . it was still under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in the customers." [Emphasis supplied.]

As the court stated in Earll v. Picken, 113 F. 2d 150, 156 (C.A. D.C., 1940):

> "He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector."

When a broker-dealer places himself in a position of trust and confidence with his customer, he thereby becomes a fiduciary and is subject to the obligations and responsibilities of a fiduciary.[18/]

With this background, we turn to the specific abuses involved in the present case -- the "churning" of customers' accounts and the cross-trading or switching of securities from one account to another. J. Logan & Co. and its salesmen induced their customers to place trust and confidence in them and to rely on them to act in the customers' best interests. Then, in order to generate profits for themselves and in complete disregard of the customers' financial welfare or investment aims they induced frequent and excessive transactions (commonly known as "churning" of accounts) and often recommended the purchase of a security to one customer while simultaneously persuading another customer to sell the same security, without disclosing the contradictory recommendations to either customer.

These practices have been condemned by the Commission in a number of opinions;[19/] and in the leading case of Norris & Hirshberg, Inc. v.

18/ See 3 Loss, Securities Regulation 1500-08 (2d ed. 1961).

19/ E. H. Rollins & Sons, Inc., 18 S.E.C. 347, 380-82 (1945)(excessive trading); Norris & Hirshberg, Inc., 21 S.E.C. 865, 886, 890-94 (1946), aff'd sub nom. Norris & Hirshberg, Inc. v. Securities and Exchange

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Securities and Exchange Commission, 177 F. 2d 228, 232 (1949), the Court of Appeals for the District of Columbia, in affirming a revocation order based upon such practices, described the churning and cross-trading activities there involved and then stated:

> "All this occurred. . . while the trusting clients were all convinced that petitioner was acting for them and in their best interest. We cannot visualize any circumstances to which the statutory phrase 'manipulative, deceptive, or other fraudulent device or contrivance' applies more aptly than the present one." 20/

Petitioner does not dispute the Commission's finding that J. Logan & Co. and its other salesmen engaged in a fraudulent scheme in violation of the federal securities laws. His argument is that the evidence does not show either that he knowingly participated in the scheme or that he otherwise violated the antifraud provisions. As we will later demonstrate, the

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Commission, 177 F.2d 228 (C.A. D.C., 1949)(excessive trading and cross-trading); Behel, Johnsen & Co., 26 S.E.C. 163 (1947) (excessive trading); Walter S. Grubbs, 28 S.E.C. 323, 328-30 (1948)(excessive trading); R. H. Johnson & Co., 36 S.E.C. 467 (1955), aff'd per curiam sub nom. R. H. Johnson & Co. v. Securities and Exchange Commission, 231 F. 2d 523 (C.A. D.C., 1956), cert. denied, 352 U.S. 844 (1956) (excessive trading); Looper and Co., 38 S.E.C. 294 (1958)(excessive trading and cross-trading); Reynolds & Co., 39 S.E.C. 902, 905-07 (1960) (excessive trading).

20/ See also R. H. Johnson & Co. v. Securities and Exchange Commission, (continued)

evidence shows that petitioner was fully aware of what the company and the other salesmen were doing and that, with such knowledge, he aided and abetted their fraudulent operation. The Court need not reach that issue, however, because entirely apart from what the others did petitioner's own conduct was, by itself, violative of the antifraud provisions.

Through his telephone solicitations petitioner sought customers like Miss Sands and Mrs. Reynolds who had little or no experience in securities trading and urged them to rely upon him to act in their best interests. He falsely represented that the company had an $800,000 research budget. Upon ascertaining what securities his customers owned, he recommended that they dispose of their holdings and reinvest in other securities. On his recommendation, Mrs. Reynolds in less than two months' time disposed of her entire $57,000 portfolio, including shares of stock in a number of well-known companies. In a little over a year, 96 transactions were effected in her account. He falsely represented that if he made money, he would make money too. He effected an unauthorized transaction for Miss Sands. In his dealings with Sinette, he accused a former salesman of having made a misrepresentation and then urged Sinette to dispose of his holdings and purchase other securities. He offered to sell Sinette's securities without charge and then deducted commissions on some of the sales. He assisted another salesman in pressuring Mrs. Hauhart to make a purchase, without disclosing to her that she was

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supra note 19. Cf. R. H. Johnson & Co. v. Securities and Exchange Commission, 198 F. 2d 690 (C.A. 2, 1952), certiorari denied, 344 U. S. 855 (1952), affirming R. H. Johnson & Co., 33 S.E.C. 180 (1952).

buying warrants rather than shares of stock. Particularly flagrant was his action in inducing four cross-trades between the Reynolds and Hulbush accounts by simultaneously making opposite recommendations to each of these customers.

Even if each thing that petitioner did is viewed in isolation from his overall course of conduct, he can hardly be considered innocent. Thus, to cite a few examples, his misrepresentation about the company's research budget was plainly fraudulent, without regard to anything else he did. So, too, was his statement to Mrs. Reynolds that he would make money if she made money.[21/] And the execution of an unauthorized transaction for Miss Sands was a violation of the implied representation that he would execute only such transactions on behalf of customers as are authorized. See First Anchorage Corp., 34 S.E.C. 299, 304 (1952).

But serious as these violations are - and we do not wish to minimize their importance - they were merely part of a course of conduct which represented a deliberate plan by petitioner to violate the trust and confidence of his customers. The fallacy that permeates petitioner's entire argument is his attempt to isolate each thing that he did from his overall pattern of conduct. His argument is not a novel one. Indeed, it has been rejected by the courts repeatedly, even in criminal cases.

21/ See United States v. Ross, CCH Fed. Sec. L. Rep. ¶ 91,251, at 94,132 (C.A. 2, July 5, 1963), where the court observed that a similar statement was "plainly" fraudulent under the Securities Act as well as under earlier statutes.

Thus, in affirming a conviction under the mail fraud statute for engaging in the fraudulent sale of securities, the Court of Appeals for the Fourth Circuit stated in Aiken v. United States, 108 F. 2d 182, 183 (1939):

> "Fraudulent intent, as a mental element of crime, (it has been observed) is too often difficult to prove by direct and convincing evidence. In many cases it must be inferred from a series of seemingly isolated acts and instances which have been rather aptly designated as badges of fraud. When these are sufficiently numerous they may in their totality properly justify an inference of a fraudulent intent; and this is true even though each act or instance, standing by itself, may seem rather unimportant. Analogies are always dangerous but sometimes rather helpful. So the old analogy of the rope seems in order: any single strand may easily be pulled apart, but many weak strands combined into a single rope may have such tensile strength as to resist the efforts even of a giant to tear it asunder. . . ."[22/]

22/ Similarly, another court said, in a case involving, inter alia, a violation of the Securities Act antifraud provisions: "Acts innocent in themselves may yet in combination constitute a fraud or attempts to commit fraud." Holmes v. United States, 134 F. 2d 125, 134 (C.A. 8, 1943), certiorari denied, 319 U. S. 776 (1943). See also Wager v. Hall, 83 U. S. (16 Wall.) 584, 601-02 (1872);

(continued)

Petitioner's overall course of conduct clearly evinced a design to induce trading in complete disregard of his customers' best interests and in violation of his fiduciary obligations to persons who had been induced to place their trust and confidence in him.[23/]

Castle v. Bullard, 64 U. S. (23 How.) 172, 187 (1859); Walters v. United States, 256 F. 2d 840, 841 (C.A. 9, 1958), certiorari denied, 358 U. S. 833 (1958); United States v. Vandersee, 279 F. 2d 176, 179 (C.A. 3, 1960), certiorari denied, 364 U. S. 943 (1961); Hunter v. Shell Oil Co., 198 F. 2d 485, 489-90 (C.A. 5, 1952); Connolly v. Gishwiller, 162 F. 2d 428, 433-34 (C.A. 7, 1947), certiorari denied, 332 U. S. 825 (1947); Nassan v. United States, 126 F. 2d 613, 615 (C.A. 4, 1942); Gates v. United States, 122 F. 2d 571, 575 (C.A. 10, 1941), certiorari denied, 314 U. S. 698 (1942); Federal Corp., 25 S.E.C. 227, 230 (1947).

23/ Cf. Stephens v. United States, 41 F. 2d 440, 445, 447 (1930), certiorari denied, 282 U. S. 880 (1930), where this Court stated:

> ". . . [A] business lawful in form and appearance does not escape the denunciation of the criminal statutes when it is commonly furthered by the use of deception and fraudulent practices.
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> * * *
>
> "If fraudulent in imporatant and continuing branches of its activities, the enterprise as a whole may properly be characterized as a fraudulent scheme."

Turning to the relationship between petitioner's conduct and the company's fraudulent method of operation, it is significant that petitioner's activity was alsmost a carbon copy of the pattern employed by the company and the other salesmen. Indeed, this similarity extended even to such details as the specific type of misrepresentation that was made concerning the research department. Thus, while petitioner represented that the company had an $800,000 research budget, another salesman told a customer that the company had a ten-man research board and still another salesman referred to the company's twenty-man research department (R. 6447, 6449). The similarity between petitioner's conduct and that of the other salesmen reinforces the conclusion that he was not acting innocently, refutes his suggestion that he had no knowledge of what the others were doing (Br. 22), and demonstrates that he played an integral and vital role in the company's fraudulent scheme. Apparently he would have this Court believe that although he was employed by J. Logan & Co. for a considerable period of time, he nevertheless worked like a hermit, was unaware of the company's policy, neither saw nor heard what the other salesmen were doing, did not know that they were abusing the trust and confidence of their customers, and by sheer coincidence just happened to follow the same modus operandi that the company encouraged and that the other salesmen used but, unlike the others, did so with innocent intent. The inference is inescapable that petitioner knew precisely what was going on and that when he adopted the same pattern of conduct which the firm and the other salesmen followed, he did so with the same fraudulent

motive.[24/]

That petitioner may have played a lesser role in the fraudulent scheme than some of the others does not absolve him from liability. Even minor participants in fraudulent securities operations have been held liable, both in civil and in criminal proceedings. In Berko v. Securities and Exchange Commission, 316 F. 2d 137 (C.A. 2, 1963), a salesman was held to be a cause of the revocation of the registration of a broker-dealer for whom he had worked only six months.[25/] In holding that an employee may not justifiably rely on sales literature furnished by an employer who is engaged in a fraudulent sales campaign, the court observed that such a salesman must be held to "a higher duty to prospective

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24/ See Walters v. United States, 256 F. 2d 840 (C.A. 9, 1958), certiorari denied, 358 U. S. 833 (1958), involving a conviction for engaging in a scheme to defraud in violation of the Securities Act. In commenting on the sufficiency of the evidence to prove criminal intent, this Court pointed out (p. 841) that "good faith is an operation of the mind of the individual and can be proven only by inference." The Court then stated (p. 842): "The existence of a uniform pattern of misrepresentation used by all defendants is patent."

25/ Lile,on the other hand, was employed by J. Logan & Co. at least from August 1956 to June 1958 (R. 237-38, 5248).

ustomers than a salesman working out of a legitimate sales operation." 16 F. 2d at 142. In United States v. Ross, CCH Fed. Sec. L. Rep. 91,251 at 94,131 (C.A. 2, July 5, 1963), a salesman who had been mployed for seven days by a broker-dealer engaged in a fraudulent sales peration was held criminally liable on the basis of a telephone call hat he had made five days after starting work. Judge Friendly commented hat the five days should have sufficed to teach "anyone" exactly what as going on. See also Van Riper v. United States, 13 F. 2d 961, 965, 66 (C.A. 2, 1926), certiorari denied, 273 U. S. 702 (1926), where Judge earned Hand pointed out that minor participants in a stock selling cheme might be convicted of mail fraud and conspiracy. It is well ettled that when persons are associated in an unlawful enterprise, the ct of one is deemed to be the act of all. Coplin v. United States, 3 F. 2d 652, 660-61 (C.A. 9, 1937), certiorari denied, 301 U. S. 703 1937). Petitioner "joined the enterprise, and was a part of the scheme. t was not necessary that he participate to the same extent as each of he other . . . [participants]." Gates v. United States, 122 F. 2d 571, 79 (C.A. 10, 1941), certiorari denied, 314 U. S. 698 (1942).

Petitioner contends that the acts of the other salesmen are not dmissible against him (Br. 22). It is not entirely clear what the asis of his objection is, although he does assert that no conspiracy was oved. It was proved, however, and also found, that petitioner partic- ated in a fraudulent scheme (R. 6450), and as this Court said in Robinson United States, 33 F. 2d 238, 240 (1929), "a scheme to defraud, when ared in by several, becomes a conspiracy, and, if a conspiracy exists fact, the rules of evidence are the same as where a conspiracy is

charged." See also Coplin v. United States, 88 F. 2d 652, 660-61 (C.A. 9, 1937), certiorari denied, 301 U. S. 703 (1937). A similar objection was also considered in the recent decision in United States v. Ross, CCH Fed. Sec. L. Rep. ¶ 91,251 at 94,134 (C.A. 2, July 5, 1963), a criminal prosecution which, like the present case, involved a charge of engaging in a scheme to defraud in violation of the Securities Act. Although the defendants, two salesmen for a securities firm, were also charged with conspiracy, the conspiracy count was dismissed during the trial. On appeal it was urged that in the absence of a finding of conspiracy the trial judge improperly admitted evidence of fraudulent statements made by a fellow salesman of the defendants. These statements were made four months after one of the defendants had already terminated his employment with the securities firm involved. Writing for the court of appeals, Judge Friendly rejected both relevancy and hearsay objections. With respect to the relevancy of the disputed testimony, he said:

> ". . . [A] 'scheme' involves some connotation of planning and pattern, and it is hard to doubt that evidence showing that the conduct charged to a defendant followed a pattern of fraud similar to one that was being contemporaneously practiced by a fellow employee, or even that was followed later by another employee of the same house with respect to the same stock, has enough logical bearing to pass the test of relevancy."

Insofar as any hearsay objection was concerned, the court, after noting that the fraudulent utterances had been offered "as acts rather than as

declarations," stated:

> ". . . [W]e see no reason why the admissibility of relevant 'acts,' as distinguished from declarations, of an associate need rest on the existence of a conspiracy, since no hearsay problem is involved."

Petitioner is especially indignant over the finding that the cross-trading between the Reynolds and Hulbush accounts was in violation of the antifraud provisions (Br. 13-17). He even suggests that the finding that the company itself engaged in a practice of cross-trading is unsupported by the evidence (Br. 17-19).

Division's Exhibit 98 (R. 5535-59), a schedule of a partial sampling of the company's securities ledger for the years 1955 to 1957, shows 938 transactions — 424 sales by customers and 514 purchases by customers — in which the same securities were bought from and sold to different customers on or about the same day (R. 4263-66).[26/] Petitioner complains that the Commission investigator who compiled this schedule did not ascertain whether the company was maintaining a trading position in the securities shown thereon. We are at a loss to know what difference

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26/ Contrary to petitioner's suggestion that Exhibit 98 covers the period from 1953 to 1958, the record shows that it covers only transactions between March 1955 and May 1957 (R. 4284, 4304-05, 5535-56).

the existence of a trading position would make. The significance of Exhibit 98 lies in the fact that the company's business was generated primarily by the salesmen's recommendations rather than through unsolicited transactions (R. 2351-52, 4158-59, 4289-90, 4319, 5562). The exhibit reflects the results of the company's policy of simultaneously making conflicting recommendations to different customers, and it corroborates the testimony of a former salesman of the company relating to this practice of cross-trading. The salesman, Pierre Pambrun, testified that there was a practice of persuading one customer to sell a security on the advice that it was falling in price and at the same time persuading another customer to buy the same security on the advice that it was rising in price (R. 1950-52).[27/]

With respect to petitioner's participation in the cross-trading, the evidence shows a series of four switches of securities between the Reynolds and Hulbush accounts. Not only did all four of the switches involve the

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27/ In Norris & Hirshberg, Inc., 21 S.E.C. 865, 886 (1946), aff'd sub nom. Norris & Hirshberg, Inc. v. Securities and Exchange Commission, 177 F. 2d 228 (C.A. D.C., 1949), the Commission said: "Respondent has attempted to explain its cross-trading generally by stating that in its opinion a security might be advisable for one account at a particular time and inadvisable for another. . . . However, cross-trading was so consistent and pervasive, and such an integral part of respondent's business that we cannot help but conclude that it cross-traded for profit rather than for the general best interests of its customers."

same two customers, but the switches occurred in pairs — two on December 26, 1956, and the other two on July 10, 1957. Thus each switch was accompanied by a reverse transaction, so that the selling customer replenished her portfolio with a security which the buying customer disposed of, and the buying customer disposed of a security which the selling customer purchased. These "coincidences," when considered together with the company's practice of cross-trading and petitioner's overall course of fraudulent conduct, surely permit the inference that he induced the cross-trading for his own gain and not in the best interests of the customers.[28/]

Petitioner emphasizes that Miss Sands suffered no pecuniary loss (Br. 20), and he asserts that the transaction in Mrs. Hauhart's account was "ratified" by her (Br. 24). These factors are irrelevant. As this Court recently said, "the law appears to be well settled that . . . the government is not required to prove that anyone was defrauded or that any investor sustained loss." Farrell v. United States, ____ F. 2d ___, No. 18,241, Aug. 7, 1963, citing Bobbroff v. United States, 202 F. 2d 389 (C.A. 9, 1953). See also Llanos v. United States, 206 F. 2d 852, 855 (C.A. 9, 1953), certiorari denied, 346 U. S. 923 (1954); Berko v. Securities

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28/ Cf. Oxford Co., Inc., 21 S.E.C. 681, 690 (1946).

Petitioner states that there was no showing by the Commission that it is the practice of the trade to discuss with one customer the trading activity of another customer (Br. 16). He neglects to mention, however, that neither is it the practice of the trade to engage in cross-trading in violation of the trust and confidence of one's customers.

and Exchange Commission, 316 F. 2d 137 (C.A. 2, 1963). In the Berko opinion, it was stated, 316 F. 2d at 143:

> ". . . [W]hen the Commission's finding of 'cause' with respect to a salesman is supported by substantial evidence in the record, as it is here, the fact that the salesman's clients were not misled and indeed may even have profited from his actions is legally irrelevant. Hughes v. S.E.C., 85 U. S. App. D. C. 56, 174 F. 2d 969, 974 (1949). The Commission's duty is to enforce the remedial and preventive terms of the statute in the public interest, and not merely to police those whose plain violations have already caused demonstrable loss or injury."

While we believe that the evidence overwhelmingly supports the Commission's findings, petitioner's suggestion (Br. 12) that a standard of clear and convincing proof is applicable requires comment because of the misconception upon which it is based. Whatever the rule may be under other statutes or in other contexts, the applicable standard of review in the present case is established by Section 25(a) of the Securities Exchange Act, which provides that "the finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." Under that standard the Commission has the responsibility both of resolving conflicts in the evidence and of drawing the necessary inferences from the evidence, and in reviewing the Commission's findings the court's function is only to determine whether they are supported by substantial evidence. Archer v. Securities and Exchange Commission, 133

F. 2d 795, 799 (C.A. 8, 1943), certiorari denied, 319 U. S. 767 (1943); Hartford Gas Co. v. Securities and Exchange Commission, 129 F. 2d 794, 796 (C.A. 2, 1942). Indeed, it has been held that under the statutory standard of review, there need not even be a fair preponderance of evidence in order to sustain the Commission's findings. Wright v. Securities and Exchange Commission, 112 F. 2d 89, 94 (C.A. 2, 1940). 29/

29/ Petitioner cites (Br. 22) Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 300 F. 2d 745 (C.A. 2, 1961), an injunctive action brought by the Commission under the antifraud provisions of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6. The court, in affirming the district court's denial of a preliminary injunction, remarked that fraud must be established by clear and convincing proof. 300 F. 2d at 747. Subsequently, however, the case was heard en banc, and in a superseding opinion written by the same judge who had earlier written the panel decision, the court, although again affirming the district court's order, nevertheless made no mention of clear and convincing proof. 306 F. 2d 606 (1962). Furthermore, it should be noted that in both the panel and the en banc opinions the court was apparently of the view that the antifraud provisions of the Investment Advisers Act, unlike those of the Securities Act and the Securities Exchange Act, require proof of common law fraud, 300 F. 2d at 751 (dissenting opinion), 306 F. 2d at 610-11; and in the en banc opinion the court emphasized that it regarded the Investment Advisers Act as being narrower in scope than either of the other two Acts, 306 F. 2d at 609-10. In

(continued)

In view of petitioner's repeated references to the severe effect that the Commission's order will have upon him, it should be emphasized that the purpose of the order is not to penalize petitioner but to protect the investing public. In Pierce v. Securities and Exchange Commission, 239 F. 2d 160, 163-64 (1956), this Court said:

> "In our view, petitioner misinterprets the purpose of the broker-dealer registration law here involved. Denial of registration is not to be regarded as a penalty imposed on the broker. To the contrary, it is but a means to protect the public interest. 15 U.S.C.A. § 78o(b); Wright v. Securities and Exchange Commission, 1940, 2 Cir., 112 F. 2d 89, 94; Smolowe v. Delendo Corporation, 1940, D.C. N.Y., 36 F. Supp. 790. The Commission is given the duty to protect the public. What will protect the public must involve, of necessity, an exercise of discretionary determination. This Court ordinarily should not substitute its judgment of what would

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29/ (continued) any event, that was an appeal from a district court decision, not a petition to review a Commission order, so Section 25(a) of the Act which controls here was not involved. Certiorari has been granted, 371 U.S. 967. Cf. Ellis v. Carter, 291 F. 2d 270, 275 n. 5 (1961), where this Court commented that Rule 9(b) of the Federal Rules of Civil Procedure, which requires that averments of fraud be stated with particularity, does not apply to an action under Section 10(b) of the Securities Exchange Act, since a showing of common law fraud is not essential to establish a claim thereunder.

be appropriate under the circumstances in place of the Commission's judgment as to measures necessary to protect the public interest. Wright v. Securities and Exchange Commission, supra; cf. Shawmut Association v. Securities and Exchange Commission, 1945, 1 Cir., 146 F. 2d 791. Since the evidence substantially supports the Findings of the Commission as to violations of law by petitioner, we cannot conclude that the Commission abused its discretion in denying him registration."

It is the Commission's responsibility to supervise the operation of the securities markets, and in doing so it may bar certain persons from participating in those markets. "Serious as this personal injury may be, it is not of controlling importance as primary consideration must be given to the statutory intent to protect investors." Associated Securities Corp. v. Securities and Exchange Commission, 283 F. 2d 773, 775 (C.A. 10, 1960).

II. PETITIONER HAS FAILED TO SHOW THAT THERE WERE REASONABLE GROUNDS FOR HIS FAILURE TO ADDUCE ADDITIONAL EVIDENCE IN THE HEARING BEFORE THE COMMISSION.

Petitioner requests that this case be remanded to the Commission for the taking of additional evidence in his defense. He has failed, however, to meet the requirement of Section 25(a) of the Securities Exchange Act that he show reasonable grounds for his failure to adduce such evidence in the hearing before the Commission.[30/] Although the burden

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30/ See Southport Petroleum Co. v. National Labor Relations Board, 315 U. S. 100, 104 (1942).

of satisfying the Court of the existence of such grounds rests upon petitioner,[31] the only ground asserted by him is that he believed that the proceeding was directed exclusively against the company and not against him personally (Br. 5). Yet the record shows[32] that he was served with a copy of the order for proceedings and notice of hearing and was advised by the Secretary of the Commission that the findings in the proceeding might be binding upon him in the future. Petitioner appeared at the hearing and cross-examined three of the Commission's witnesses. In response to his assertion that he thought the proceeding was not directed against him personally but only against the company, the hearing examiner pointed out to him on the second day of the hearing that he had been named in the order for proceedings and that the charges, if proved, would affect his right to future employment. During a subsequent recess in the proceeding he was notified of the date when the hearing would be reconvened, was requested to arrange to be in daily attendance, and was specifically advised that all parties and persons named in the order for proceedings should be prepared to go forward with

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31/ National Labor Relations Board v. Jos. N. Fournier, 182 F. 2d 621, 622 (C.A. 2, 1950).

32/ We are not repeating record references to most of the factual statements in this section of the brief. Detailed references covering this same subject are in the Statement of the Case under the sub-head "The Administrative Proceeding," supra, pp. 18-21.

:heir defense at the reconvened hearing. Following the close of the
iearing, he was notified of the post-hearing filing schedule and of
i later extension of the filing dates. At his request the Commission
granted a further extension of time for filing proposed findings and
i brief. Then, on October 28, 1960 -- after the expiration of the
:xtended time for the filing of proposed findings and briefs, and
)ver two years after the institution of the proceeding -- petitioner
:equested that the record be reopened. Under these circumstances the
:ommission was certainly justified in denying the request. Indeed, any
)ther course would have further delayed an already prolonged proceeding
'hich involved the rights of numerous parties other than petitioner,
:ome of whom had requested a prompt conclusion of the proceeding on the
;round that a delay would be burdensome to them (R. 6100-01).

Moreover, the evidence that petitioner seeks to adduce before the
:ommission is, for the most part, irrelevant to the question whether he
'iolated the antifraud provisions. Basically, he contends that his
mployer advised him that churning was an ordinary and proper practice to
ngage in.[33/] This is nothing more than an assertion that he thought it was
awful to violate the trust and confidence of his customers. Obviously this
s no defense. See Arleen Hughes v. Securities and Exchange Commission,
74 F. 2d 969, 977 (C.A. D.C., 1949); Norris & Hirshberg, Inc. v. Securities

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3/ See petitioner's affidavit filed in this Court on November 7, 1962, in opposition to the Commission's motion to dismiss the petition for review.

and Exchange Commission, 177 F. 2d 228, 233 (C.A. D.C. 1949). Nor is it a defense that his misrepresentation concerning the research department was based upon information supplied by his superiors. There can be no justification for reliance on information furnished by an employer who is engaged in a fraudulent operation. See Berko v. Securities and Exchange Commission, 316 F. 2d 137, 142 (C.A. 2, 1963).

CONCLUSION

The Commission's motion to dismiss the petition for review should be granted, or, in the alternative, the order of the Commission should be affirmed.

Respectfully submitted,

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September 1963

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

_____
Attorney

APPENDIX

SECURITIES ACT OF 1933

Fraudulent Interstate Transactions

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * * *

SECURITIES EXCHANGE ACT OF 1934

Regulation of the Use of Manipulative and Deceptive Devices

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Over-the-Counter Markets

SECTION 15. (a) No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

(b) A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, such broker or dealer, as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine.

* * * *

The Commission shall, after appropriate notice and opportunity for hearing, by order deny registration to or revoke the registration of any broker or dealer if it finds that such denial or revocation is in the public interest and that (1) such broker or dealer whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such, * * * (D) has willfully violated any provision of the Securities Act of 1933, as amended, or of this title, or of any rule or regulation thereunder.

* * * *

(c) (1) No broker or dealer shall make use of e mails or of any means or instrumentality of terstate commerce to effect any transaction in, or induce the purchase or sale of, any security ther than commercial paper, bankers' accept-ces, or commercial bills) otherwise than on a tional securities exchange, by means of any nipulative, deceptive, or other fraudulent device contrivance. The Commission shall, for the rposes of this subsection, by rules and regula-ns define such devices or contrivances as are nipulative, deceptive, or otherwise fraudulent.

* * * *

SEC. 15A. (a) Any association of brokers or alers may be registered with the Commission as national securities association pursuant to sub-ction (b), or as an affiliated securities association rsuant to subsection (d), under the terms and nditions hereinafter provided in this section, by ing with the Commission a registration state-ent in such form as the Commission may pre-ribe, ...

* * * *

(b) An applicant association shall not be regis-red as a national securities association unless it ppears to the Commission that—

* * * *

(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if (1) such broker or dealer, whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such, (A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade, or (B) is subject to an order of the Commission denying or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or (C) by his conduct while employed by, acting for, or directly or indirectly controlling or controlled by, a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer;

* * * *

(l) The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest or for the protection of investors or to carry out the purposes of this section—

* * * *

(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding 12 months or to expel from a registered securities association any member thereof who the Commission finds (A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder, or (B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation;

* * * *

Court Review of Orders

SECTION 25. (a) Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such person is a party may obtain a review of such order in the Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, and enforce or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, and enforcing or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

* * * *

ENERAL RULES AND REGULATIONS
NDER THE SECURITIES EXCHANGE
CT OF 1934

Rule 10b–5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

n connection with the purchase or sale of any ecurity.

Rule 15c1–2. Fraud and Misrepresentation.

(*a*) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15 (c) (1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(*b*) The term "manipulative, deceptive, or other fraudulent device or contrivance." as used in section 15 (c) (1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(*c*) The scope of this rule shall not be limited by any specific definitions of the term "manipulative, deceptive, or other fraudulent device or contrivance" contained in other rules adopted pursuant to section 15 (c) (1) of the Act.

EXTRACT FROM TRANSCRIPT OF TESTIMONY [1]

(2608) Examiner Ewell: All right, gentlemen.

Let the record show that the hearing is reconvened in the matter of J. Logan and Company, 721 East Union Street, Pasadena, California, in connection with proceedings under Section 15 (b) of the Securities and Exchange Act of 1934, Commission Docket Number 8-4128.

The hearing is being reconvened pursuant to a notice sent out by the Hearing Examiner, dated September 25th, 1959, directed to J. Logan and Company and to other persons named in the order for proceedings.

The hearing was recessed on or about April 30th, 1959, after a number of sessions, daily sessions, following the opening of the hearing

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[1] Pages 2608-11 of the transcript of testimony were not designated as part of the record on review. We are relying on these pages solely in connection with petitioner's application for leave to adduce additional evidence. In ruling on an application of this nature the Court may consider matters outside the record, such as affidavits. See Southport Petroleum Co. v. National Labor Relations Board, 315 U. S. 100, 103 (1942); National Labor Relations Board v. Forest Lawn Memorial Park Ass'n., 198 F. 2d 71 (C.A. 9, 1952); National Labor Relations Board v. Jos. N. Fournier, 182 F. 2d 621, 622 (C.A. 2, 1950). Accordingly, we are furnishing the Court a certified copy of pages 2608-11 of the transcript, and for the convenience of the Court and the parties we are reproducing the pertinent portions of those pages in the appendix to our brief. We assume that the affidavit of the petitioner, filed on November 7, 1962, will also be considered by the Court in

and was recessed at that time subject to the call of the Hearing Officer, and pursuant to that arrangement, as noted on the record at that time, the notice dated September 25th was sent out.

That notice read as follows:

"J. Logan & Company

721 E. Union St.

Pasadena, Calif.

Re: Proceedings under Section 15 (b) of the Securities Exchange Act, File No. 8-4128.

Gentlemen:

This is to notify you that the hearing in the (2609) above matter, which was recessed subject to the call of the hearing officer, will be reconvened on Thursday, October 15, 1959, at 10:00 a.m. in the branch office of this Commission located at 6331 Hollywood Boulevard, Los Angeles, California.

"In view of the extended adjournment all parties and participants and their counsel are requested to arrange to be in attendance at the hearing daily until all testimony to be adduced on behalf of the Division of Trading and Exchanges of the Commission has been concluded. And for your further information and guidance, it is understood that there are some fifty or more witnesses still to be heard from on behalf of said Division.

"Very truly yours,

"James G. Ewell, Hearing Examiner."

Copies of that notice were sent to Mr. Norman M. Walker, Esquire, 9606

Santa Monica Boulevard, Los Angeles, California; Howard M. Rhodes, Esquire, 902 Bay Cities Building, Santa Monica, California; David S. Robertson, Esquire, 650 South Grant Avenue, Los Angeles 17, California; and Mr. Charles R. Burr, Regional Administrator, Los Angeles Branch Office; Mr. James C. Flanagan, 9937 Ahmann Avenue, Whittier, California; Mr. Allen Sterling, 15900 Simonds Street, Grenada Hills, California; Mr. Claude S. Jameson, Jr., Vice President (2610) Trading Department, 423 Meadow Grove Street, Flintridge, California; Mrs. Mildred Baxter Logan, care of Logan and Company, 721 East Union Street, Pasadena, California; Mr. Benjamin Berk, 522 South Kelso Street, Inglewood, California; Mr. Trennis K. Lile, 1853 Meadowbrook Street, Altadena, California; Mr. Miles Hollister, 31214 Ballaird Road, Malibu, California; Mr. Carl Sarafian, 451 Martello Avenue, Pasadena, California, and Mr. Frank Niles, 8451 East Beverly, San Gabriel, California.

These notices were all sent by registered mail, return receipt request.

The return receipts will be on file in the office of the Commission in Washington.

Following this notice, the Examiner sent out another letter to the parties and persons named in the Commission's order by reason of the fact that, subsequent to sending out that letter, it came to the attention of the Examiner that the number of witnesses referred to therein, which was stated as fifty or more to be heard on behalf of the Commission, had been substantially reduced, and so the Examiner directed the following letter, dated October 7, 1959, which was sent to all of these same parties and persons mentioned above.

This letter went by air mail to the following effect.

After recital of the title of the case or the proceeding, the letter states as follows:

(2611) "Since advising you that the hearing in the above matter will be reconvened on October 15, 1959, it has come to my attention that the number of witnesses to be called by counsel for the Division of Trading and Exchange will probably be reduced substantially below the number referred to in my letter of September 25, 1959.

"For this reason, and also because of the long period of recess, it is requested that all parties and persons named in the Commission's Order for Proceedings, and their counsel, be prepared to go forward with evidence in defense of the Commission's charges immediately upon conclusion of the direct testimony in respect thereof.

"Very truly yours,

"James G. Ewell, Hearing Examiner."

I believe that the recitation of the persons whom these letters and notices were sent to constitute all of the persons named in the Commission's Order for Proceedings, and I think now they are ready to proceed with the taking of testimony.

No. 18209

United States
COURT OF APPEALS
for the Ninth Circuit

WILLIAM J. WINEBERG and the ESTATE OF JANET R. WINEBERG, DECEASED, WILLIAM J. WINEBERG, EXECUTOR,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Appeal from the Tax Court of the United States

PETITION FOR REHEARING

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No. 18209

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WILLIAM J. WINEBERG and the ESTATE OF JANET R. WINEBERG, DECEASED, WILLIAM J. WINEBERG, EXECUTOR,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Appeal from the Tax Court of the United States

PETITION FOR REHEARING

PETITION FOR REHEARING

Come now William J. Wineberg and the Estate of Janet R. Wineberg, Deceased, William J. Wineberg, Executor, the petitioners in the above-entitled proceeding, appearing by Charles P. Duffy, one of their attorneys of record, and respectfully present this petition for rehearing on the following grounds:

1. The Court concluded that "petitioner was engaged in the trade or business of selling timber" by interpret-

ing the phrase "trade or business" in the light of earlier cases on this subject, and did not mention nor apply the 1963 decision of the Supreme Court in *A. J. Whipple* v. *Commissioner,* 373 U.S. 193, 83 S. Ct. 1168, in which the Supreme Court concluded, once again, that there is a big difference between engaging in income-producing activities and being actively engaged in the pursuit of a trade or business. The *Whipple* decision was not mentioned in the briefs filed by the respective parties herein, since that case had not been decided by the time that the reply brief was due. It was called to the attention of the Court, however, at the time of the oral argument herein.

The phrase "trade or business" found in Section 117 (a) of the Internal Revenue Code of 1939, which defined "capital asset", is precisely the same phrase found in Section 23 (k) of the same Code, which was involved in the *Whipple* case. The Court stated:

> "Congress deliberately used the words 'trade or business', terminology familiar to the tax laws, (in enacting the bad debt provisions) . . . a concept which falls far short of reaching every income or profit-making activity."

The Court, in *Whipple,* made it clear that "investing is not a trade or business", and stated that:

> "As early as 1916, Congress . . . distinguished the broad range of income or profit-producing activities from those satisfying the *narrow category* of trade or business." (italics supplied)

In *Whipple,* the Commissioner of Internal Revenue argued successfully that "trade or business" embodied a very narrow concept. In the present case, the same

phrase appearing in Section 117(a) is applied with a broad brush in order to sustain the Commissioner's position here.

The Commissioner uses this phrase with a "heads I win, tails you lose" attitude. We submit that the Commissioner should not be permitted to blow hot and cold in applying this phrase. It is respectfully submitted that the opinion of this Court in the instant case will permit and encourage him to do so.

It is unfortunate that this Court has placed principal emphasis on the facts relating to the Wineberg Timber Company, as set forth in paragraphs 11 to 25, inclusive, of the factual statement in the opinion, since the record (R. 296) shows that petitioner "spent very little time in Newport, Oregon". Moreover, that office was maintained for the principal purpose of "administering certain contracts of sale and watching operations" in Lincoln County, Oregon, (R. 272, 295); namely, the Monroe contract and the Cascadia contract (R. 301-2).

2. With respect to issue No. 2, it is respectfully submitted that Section 117(k) merely enlarged the word "sales" to include dispositions which would otherwise not be sales, and that Section 117(j) granted capital gains on sales of timber under the enlarged definition of the word "sales". We believe that this follows from the opinion of this Court in *United States* v. *Giustina,* et al, 313 F.2d 710, decided December 17, 1962.

3. With respect to the Monroe Lumber Company-Kendall tract transaction, set forth on pages 17 to 19, inclusive, of the opinion of the Court, there is nothing

No. 18209

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE PETITIONERS

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INDEX

INDEX (Cont.)

TABLE OF AUTHORITIES

Page

Decisions

TABLE OF AUTHORITIES (Cont.)

No. 18209

United States
COURT OF APPEALS
for the Ninth Circuit

WILLIAM J. WINEBERG and the ESTATE OF JANET R. WINEBERG, DECEASED, WILLIAM J. WINEBERG, EXECUTOR,
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Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE PETITIONERS

OPINION BELOW

The memorandum, findings of fact and opinion of the Tax Court (R. 84-198) are not reported officially.

JURISDICTION

On May 11, 1962, the Tax Court of the United States entered its decision determining deficiencies in

income taxes and additions to the tax due from the petitioners as follows:

Year	Income Tax	Section 294(d) (1939 Code)
1950	$18,902.06	--
1951	32,562.22	--
1952	45,887.27	$9,318.96
1953	34,882.63	4,558.07

A timely petition for review thereof was duly filed with this Court on August 7, 1962 (R. 203). Jurisdiction is conferred on this Court by Sections 7482 and 7483 of the Internal Revenue Code of 1954.

SPECIFICATION OF ERRORS

1. The conclusions of law made by the Tax Court are erroneous in the following particulars:

(a) The Tax Court erred in its interpretation and application of Section 117(a) of the Internal Revenue Code of 1939.

(b) The Tax Court erred in its interpretation of, and failure to apply, the provisions of Sections 117(k) and 117(j) of the Internal Revenue Code of 1939.

(c) The Tax Court erred in its interpretation of, and failure to apply, the provisions of Section 112(b)(1) of the Internal Revenue Code of 1939 to certain exchanges of like properties by petitioners.

(d) In the alternative, the Tax Court erred in its interpretation of, and failure to apply, the provisions of Section 117(k)(2) of the Internal Revenue

Code of 1939 to certain dispositions of timber by petitioners.

(e) The Tax Court erred in its interpretation of, and failure to apply, the provisions of Section 23(o) of the Internal Revenue Code of 1939 to a charitable contribution made by petitioners in the year 1953.

2. The Findings of Fact made by the Tax Court are clearly erroneous in the following particulars:

(a) The Tax Court erred in determining that the timber sold or exchanged by petitioners during the taxable years was theretofore held primarily for sale to customers in the ordinary course of petitioners' trade or business, within the purview of Section 117(a) of the Internal Revenue Code of 1939.

(b) In the alternative, petitioners contend that the Tax Court erred in determining that the petitioners did not retain an economic interest in the disposition of certain timber during the taxable years, within the purview of Section 117(k)(2) of the Internal Revenue Code of 1939.

(c) The Tax Court erred in determining that certain "production royalties" received by petitioners during the years 1951, 1952 and 1953 constituted ordinary income to petitioners rather than long term capital gains.

(d) The Tax Court erred in determining that an amount received by petitioners in 1950 for use of a logging road constituted ordinary rental income

to petitioners, rather than long term capital gain from the grant of an easement.

(e) The Tax Court erred in determining that petitioners did not sustain a short term capital loss of $10,000 from the sale of certain shares of stock of Yaquina Bay Mills, Inc. in the year 1951.

(f) The Tax Court erred in determining that an amount paid by petitioners in 1953 to a church did not constitute an allowable charitable deduction.

3. The Tax Court erred in determining any income tax deficiency against petitioners for any of the years 1950 to 1953, inclusive, and erred in failing to find overassessments for the years 1951, 1952 and 1953.

4. The Tax Court erred in imposing an underestimate penalty against petitioners for either of the years 1952 or 1953, under the provisions of Section 294(d) of the Internal Revenue Code of 1939.

STATEMENT OF THE CASE

The principal issue in this case is whether petitioners realized capital gains or ordinary income from the sale of certain tracts of timber during the years 1950 to 1953.

There is no real dispute as to the facts. Petitioner William J. Wineberg was and is an investor in many types of properties (R. 211). During the late 1920's (R. 87), the 1930's, and the early 1940's, he acquired a considerable number of tracts of timber, mostly in Ore-

gon and Washington, at property tax delinquency sales (R. 88, 266-7) at what now appear to be extremely low prices. The economic upturn and the resulting inflation during the years of World War II and thereafter caused stumpage prices to multiply by leaps and bounds. During the years 1950 to 1953 petitioners sold or disposed of less than eight per cent of their timber holdings (R. 93, 95-6, 212) to individuals or firms who approached the petitioners to acquire certain of the properties (R. 260).

None of the properties was advertised for sale (R. 259); no offers were solicited on any tract of timber; petitioners had no fixed price for the sale of such properties; in each instance the ultimate purchaser approached the petitioners to acquire the property; petitioners never improved any of the properties in any way; never constructed logging roads to any of the properties in order to make them more salable; posted no signs on any of the properties indicating that they were for sale; and employed no salesman to sell any of the tracts of timber (R. 260).

Despite these undisputed facts, Judge Irene F. Scott of the Tax Court held that the timber tracts in question were theretofore held by petitioners primarily for sale to customers in the ordinary course of business and were, therefore, not "capital assets" within the purview of Section 117(a) of the Internal Revenue Code of 1939. Reaching that conclusion, she reclassified the sale proceeds from capital gains to ordinary income.

There are certain subsidiary and relatively minor

issues involved in this case which will be discussed under the appropriate headings of the argument. These relate to questions of whether certain transactions constituted tax-free exchanges of "like kind" properties; whether certain "production royalties" received by petitioners during the years 1951, 1952 and 1953 constituted long term capital gains or ordinary income; whether the amounts received during 1950 for a logging road easement constituted ordinary rental income, rather than long term capital gains; whether petitioners sustained a short term capital loss from the sale of certain shares of stock in the year 1951; and whether the petitioners were entitled to a claimed charitable deduction in the amount of $5,000 made by them in the year 1953.

STATUTES INVOLVED

INTERNAL REVENUE CODE OF 1939:

Sec. 117(a)

"(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;"

Sec. 117(j)

"(1) Definition of Property Used in the Trade or Business—For the purpose of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . . Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable."

Sec. 117(k)

"Gain or Loss in the Case of Timber or Coal.—

. . . . .

"(2) In the case of the disposal of timber or coal . . . held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the amount received for such timber or coal and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal. . . ."

Sec. 112(b)

"Exchanges Solely in Kind.—

"(1) Property Held for Productive Use or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for

property of a like kind to be held either for productive use in trade or business or for investment."

Sec. 23

"Deductions from Gross Income.—

"In computing net income there shall be allowed as deductions:

. . . . .

"(o) Charitable and Other Contributions. — In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of:

"(1) . . . . .

"(2) A corporation, trust, or community chest, fund or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation."

SUMMARY OF ARGUMENT

None of the specific tracts of timber sold by petitioners during the taxable years before the Court were theretofore held by them primarily for sale to customers in the ordinary course of business. They were, therefore, "capital assets" in the hands of petitioners and the sales proceeds constituted capital gains.

It is respectfully submitted that the length of hold-

ing—an average of about eight years—and the lack of "busy-ness" on the part of petitioners in bringing about such sales, are the principal factors confirming the taxpayers' contention that the timber in question was acquired and held for investment.

Most of the tracts of timber in question were acquired prior to World War II at property tax delinquency sales for prices that now appear to be very low. Despite the tremendous increment in timber stumpage values brought on by the wartime inflation, petitioners disposed of only a small percentage of their timber holdings during the taxable years before the Court and still retain most of their timber to this date, despite numerous offers.

It is true that petitioner William J. Wineberg had a number of transactions with the logging and lumber industry during these years, but had even more numerous transactions in the stock market, as evidenced by his income tax returns. The respondent, inconsistently, has made no effort to reclassify the proceeds of such gains from the sale of corporate stock. Petitioners had investments in many areas and in many fields of endeavor (Exs. 1-A, 2-B, 3-C, 4-D). In any event, petitioners respectfully submit that whether land or timber constitutes a capital asset in the hands of a given taxpayer depends not on *who* owns the land or timber, but on *how* it is held. Land or timber is either held for investment and is a capital asset or is held for sale to customers in the ordinary course of the taxpayer's trade or business. We believe that nothing in the record

supports respondent's contention and the determination by the Tax Court that petitioner was a "dealer", but it should be unimportant to what extent the taxpayer may have been in the timber business; the sole question should be whether the property from which the gain was derived was within the statutory definition of a capital asset.

It is readily apparent that petitioners were holding the property and not selling it because they expected the property to further appreciate in value and thus increase the profit that they would ultimately receive upon the disposition thereof. This is the characterstic of an investor—not a "dealer".

In the alternative, petitioners contend that a proper interpretation and application of Sections 117(j) and 117(k) of the Internal Revenue Code of 1939 would grant them capital gains on all timber sales, regardless of the purpose for which the timber was held.

The subsidiary issues are discussed under the separate headings of Sections III to VIII, inclusive, of the Argument.

ARGUMENT

I.

None of the specific tracts of timber in question were held by petitioners primarily for sale to customers in the ordinary course of business, within the purview of Section 117(a)(1) of the Internal Revenue Code of 1939.

For the convenience of the Court, we have included herein, as Appendix A, a brief summary of the timber transactions which are in dispute. It will be noted that

these tracts were held by the petitioners for an average of about eight years and that some of the "sales" were caused by unauthorized trespassers cutting their timber.

Petitioners also sold or disposed of other timber during the years 1950 to 1953 under contracts by which they retained an economic interest in the timber, within the purview of Section 117(k)(2) of the Internal Revenue Code of 1939. These transactions are summarized in Appendix B hereto. The respondent has not questioned the petitioners' right to capital gains treatment of these amounts.

Like the numerous lots purchased by the taxpayers in *W. E. Starke* v. *Commissioner,* — F.2d —, decided by this Court on January 10, 1963 (No. 17,337), and *Austin* v. *Commissioner* (1959), 263 F.2d 460, most of the properties were acquired by petitioners at tax delinquency sales in the late 1920's, the 1930's or early 1940's (R. 266-7).

The petitioner William J. Wineberg testified that each property was acquired and held strictly for investment purposes (R. 256-7). We anticipate that respondent will seek to discount this testimony of the petitioner as being self-serving, but the Commissioner offered no evidence to the contrary. Cf. *Ross* v. *Commissioner,* 5 Cir., 227 F.2d 265, cited in *Starke* v. *Commissioner,* supra. In any event, there should be no dispute between the parties that no property was advertised for sale; no offers were solicited on any tract of timber; petitioners had no fixed price for the sale of such properties; in each instance the ultimate purchaser

approached petitioners to acquire the property; petitioners never improved any of the properties in any way; petitioners never constructed logging roads to any of the properties in order to make them more salable; petitioners posted no signs on any of the properties indicating that they were for sale; and petitioners employed no salesmen to sell any of their tracts of timber (R. 259-260).

In dispute is the nature of the proceeds of the sale of some twenty-seven tracts of timber during the four years in question, five of such sales being of an involuntary nature caused by unauthorized trespasses. With respect to the latter, the Tax Court even seems to have held that the petitioners were holding their properties for sale to such trespassers.

The most recent decision of this Court on this general issue was in the case of *W. E. Starke* v. *Commissioner,* — F.2d —, decided January 10, 1963 (No. 17, 337). It is interesting to note that Judge Scott relied on the *Starke* case (R. 169)—prior to its reversal by this Court—in deciding the instant case. The Court will recall that the taxpayer in that case was a lawyer who had acquired a great many lots at property tax delinquency sales through the medium of improvement bonds. The tax years 1953 to 1955, inclusive, were involved in that case, and the profit from the sales of real property in those years far exceeded the net income of the taxpayer from his law practice. In addition to the sales of real property during the taxable years before the Court, the taxpayers had sold a number of lots,

both prior to those years and subsequent thereto. As the Tax Court pointed out in its opinion, 35 T.C. 18, at 24, the petitioner received profits during 1953 from 81 installment sales made prior to 1953. At page 26 of its opinion, the Tax Court recites the fact that Mr. Starke, during the year 1953, made a total of 68 real property transactions involving 139 lots. In 1954, he had a total 41 transactions involving 89 lots, and in 1955 there was a total of at least 25 sales involving 59 lots. In the next year, the large number of sales continued, there being 25 sales involving a total of 80 lots. The taxpayer argued unsuccessfully in the Tax Court that he devoted most of his time to his law practice, but the Tax Court stated:

> "We think there was certainly 'busyness' on the part of the petitioner in the acquisition and sale of the large number of lots dealt with in the years in question and prior thereto. The petitioner, either personally or through his secretary, was consistently engaged in the activity of acquiring title to lots, discussing proposed sales, and transferring title to lots. A lack of 'busyness' with respect to solicitation of purchasers is not decisive where, as here, there was a seller's market and purchasers sought out the petitioner."

The Tax Court refused to follow the earlier decision of this Court in *Austin* v. *Commissioner,* 263 F.2d 460, which had reversed an earlier opinion of the Tax Court. On appeal, this Court, in the *Starke* case, reversed the Tax Court again and held, for the following reasons, that the taxpayer was entitled to capital gains treatment of the proceeds from the numerous sales of lots:

> "The days that Starke must have been waiting

for came in the war time years of 1941-1945 and again in 1953, 1954 and 1955. San Diego was experiencing an economic upturn which brought lot buyers to Starke's door. He had the lots. They bought, and he sold. There was considerable profit. Starke, in 1953 and thereafter, continued to treat his profits as capital gains, as he had done through the preceding years. But the commissioner has taken the position for the years 1953, 1954 and 1955 that Starke was in the business of selling lots: ergo, he must treat the profit as ordinary income and cannot retain his own theory of capital gains. On redetermination, the tax court has sustained the commissioner. Its decision, 35 T.C. 18, is here for review. We agree with the taxpayer.

. . . . .

"No one element is dispositive. But here there is no evidence of a campaign to sell, no advertising, no 'holding out'. Purchasers had to find Starke. Certainly prior to 1941-1945 and 1952-1955 one would be hard pressed to say Starke was in the business of selling lots. We do not think under all of the circumstances that his decision to unload in the sellers market of 1953-1955, when buyers came to his door, should charge Starke with an interlude of business. True, his profit is measured by the year, but 'business' as distinguished from 'investment' should be measured by the course of the known years. It is in measuring the whole course here that we conclude he had investment. The active business shown by Starke was that of a practicing lawyer. We believe had the taxpayer been involved in the same number of stock purchases and sales at the same costs and selling prices on the same dates, no one would have questioned his right to capital gains."

Unlike *Starke* and *Austin,* petitioner William J. Wineberg was not a member of the bar. He was and is an investor (R. 211) or, if you will, a capitalist. It is

submitted that his relationship to the properties was as passive as the lawyer's in those cases.

It is true that petitioner William J. Wineberg made a certain number of timber sales during the years in question, but it is equally true that he made numerous and more frequent sales of corporate securities on the stock exchange during these years. An examination of the income tax returns of petitioners for the years in question (Exs. 1-A, 2-B, 3-C and 4-D) indicates that the petitioners were actively engaged in buying and selling in the stock market—not in selling timber. For example, in filing their joint income tax return for the year 1950 (Ex. 1-A), petitioners reported nine sales of timber during such year, which were reported by them as long-term capital gains. The gross selling price of these tracts of timber was $95,526.11. Petitioners also reported six small sales of real property during that year, with the selling prices aggregating $16,715.45. During the same year, petitioners reported 37 separate sales of corporate securities for sales prices aggregating $190,-284.86, as long-term capital gains, and also reported 9 separate other sales of corporate securities as short-term capital gains, with aggregate sales prices of $28,161.73. Respondent, although reclassifying the gain on the outright timber sales as ordinary income, approved the capital gain treatment of the security sales despite the number of the sales and the dollar amounts involved therein.

The returns filed by petitioners for these years indicate that they had widely diversified investments during

this period. The 1953 return (Ex. 4-D) shows dividends received from 58 different corporations, rentals received from various properties, the operation of a dairy and farm, and even a race horse venture. We recognize the fact, as indicated in the *Starke* decision, that a taxpayer may be in many active businesses all at the same time and all of his businesses be subject to ordinary income rates without capital gains treatment. On the other hand, as this Court pointed out in *Austin* v. *Commissioner,* 263 F.2d 460:

> "Carrying on a business, however, implies an occupational undertaking to which one habitually devotes time, attention or effort with substantial regularity. Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable."

In the *Austin* case, supra, the petitioner had made 94 sales of real property in 10 years, and the Tax Court found that there appeared to be a more or less consistent activity in the sale of lots over a period of years, resulting in a steady flow of income. The Tax Court noted that petitioner's net profits from real estate sales were substantially in excess of the net collections from his law practice and that he must have spent considerable time in his law office drawing up sales contracts. The Tax Court rejected the petitioner's arguments that he did not advertise the lots which were, in fact, sold, upon the theory that the seller's market made such activity unnecessary. In reversing the Tax Court, this Court, citing its earlier decision in *Palos Verdes Corp.* v. *United States,* 201 F.2d 56, stated:

"It is sound law that holding an asset for many years indicates an intention to hold for investment, rather than for sale, (citations) and the long period of holding assets without being disposed of violates the concept of an organized business with respect thereto." (citations)

Commenting specifically on the contrary findings of the Tax Court in the *Austin* case, this Court declared:

"Petitioner did nothing to attract prospective buyers. Prospective buyers after checking with tax rolls would seek out the petitioner. The only time or effort devoted by petitioner was after he had been sought out by prospective purchasers or their brokers, and such time and effort related only to negotiations carried on, mostly over the telephone, as to sales prices and terms. The transactions were consummated by title companies. There is nothing in the record to suggest that such negotiations were extensive or required much effort or time.

"The profits realized by petitioners, as well as the sales, were not the result of any efforts expended by petitioner. After 1945 there was a large amount of real estate development in Manhattan Beach. Persons were seeking to buy lots there, and as a result of such demand petitioners were able to sell lots at substantial prices which he had purchased for relatively small sums or acquired in payment of legal fees. This increase in prices bore no relationship to petitioner's investment or the time he devoted to consummate sales."

* * * * *

"It is our view, based upon the entire record, that petitioner was not engaged in the business of selling real property during the tax years in question, and that the properties sold were not being held primarily for sale to customers. The conclusion of the Tax Court in our opinion is clearly erroneous, and on the entire record a mistake has been made. . . ."

We recognize that the *Starke* opinion expressly declared that it did not "impair the validity" of the following earlier cases in which this Court had held that sales of varying volume were in the ordinary course of business and the proceeds therefrom not entitled to investment treatment: *Rollingwood* v. *Commissioner,* 190 F.2d 263; *Cohn* v. *Commissioner,* 226 F.2d 22; *Homann* v. *Commissioner,* 230 F.2d 671; *Pool* v. *Commissioner,* 251 F.2d 233; *Rubino* v. *Commissioner,* 186 F.2d 304; and *Stockton Harbor Industrial Company* v. *Commissioner,* 216 F.2d 638.

Rollingwood involved the sale of more than eight hundred homes, over a four-year period, which had been constructed in a World War II housing project. The taxpayer stated that its business was "Development of subdivision and selling of homes to defense workers" (1950 TC Memo. Dec., Par 50,180). *Cohn* also involved a subdivider who built war housing units which were sold shortly after they were completed—at least, as soon as the wartime restrictions were lifted. *Homann* also involved eighty-five houses constructed in 1945 for war workers. They were sold in the following year, after removal of wartime restrictions. *Pool* involved taxpayers who were " 'speculative builders' of homes for profit, which were disposed of as quickly as possible after they were built". There was substantial selling activity. *Rubino* was the per curiam affirmance by this Court of a memorandum decision of the Tax Court in which the taxpayer stated on his income tax return that he was "engaged in building homes for sale and on contract". *Stockton Harbor* had previously filed

a document with the Bureau of Internal Revenue, stating that "the real properties of the corporation are held primarily for sale" and the evidence indicated a substantial sales effort to dispose of a large industrial tract to various customers. In each of these cases, the holding period was not more than one or two years and, in each instance, the evidence showed that only wartime restrictions and conditions prevented even earlier sales. The decisions in those cases should be compared to the war-rental housing case of *McGah* v. *Commissioner,* 210 F.2d 769, decided by this Court in 1954. In that case, it was noted that the taxpayer still was renting approximately one third of its houses and disposed of the remaining portion in order to reduce its indebtedness. The retention of a substantial portion of the rental units is, we believe, similar to the retention by the petitioner William J. Wineberg of more than nine tenths of his timber "despite a ready market and opportunity to realize large profits", as in the *McGah* case.

The average holding period of the properties disposed of during the taxable year and which are in dispute here (Appendix A) was approximately eight years. The average holding period in *Starke,* supra, was about ten years. It is readily apparent that petitioner contemplated holding these properties for a great many years and that only the phenomenal rise in the value of stumpage caused him to dispose of some of his total holdings to persons or firms who sought him out and offered to buy.

Was there any "busy-ness" on the part of petitioner

in bringing about the sale of these tracts of timber? What he *didn't* do is set out in the first part of this argument. Petitioner testified that he never saw most of the properties (R. 253). However, we anticipate that respondent will point to the frequent timber sales by petitioner during this period (but not nearly so numerous as the sales in *Starke or Austin*); the fact that petitioner had a real estate salesman's license at one time (but not since the year 1926—Ex. 43-QQ, R. 264, 302); the fact that petitioner personally approved all sales (R. 287)—any investor in the stock market does the same; the fact that petitioner required purchasers of timber, where he retained the land, to follow good forest practices; and the fact that petitioner expended funds for reseeding and pest control (R. 294-5). These, however, would appear to be attributes of the investor —not the dealer. It takes forty to seventy years for a crop of timber to grow (R. 301).

We also anticipate that respondent will contend that there was "busy-ness" on the part of petitioner in the operation of the one-room office of "Wineberg Timber Co." at Newport (Lincoln County), Oregon (R. 271), which was managed by one Ellis Moses, an employee of petitioner (R. 347). "Wineberg Timber Co." was a name assumed by petitioner in 1952 (R. 347) or 1953 (Ex. 40-NN) for the principal purpose of "administering certain contracts of sale and watching operations" in Lincoln County, Oregon (R. 272, 295), namely, the Monroe contract and the Cascadia contract (R. 301-2). During the year 1952, petitioner had log (not timber) sales of $165,000 (Ex. 3-C) and in 1953 he had

log and lumber sales of $194,000 (Ex. 4-D), all of which were reported by petitioners as ordinary income. These were from selective cutting contracts (R. 270) which required supervision. Trespasses on the timber had to be ascertained and settled (R. 262); reseeding and forest sanitation was necessary to preserve petitioner's timber holdings (R. 295); and petitioner was always desirous of acquiring more logged-off land or land and timber adjoining his holdings (R. 283, 286).

Although petitioner maintained a desk in his home (R. 306), in Vancouver, Washington, the Newport, Oregon, office received many inquiries for different tracts of land or timber owned by the petitioner (R. 348). Respondent's witness, Ellis Moses, testified, however, that there was no advertising for sale of any timber or land (R. 353). Petitioner William J. Wineberg "spent very little time in Newport, Oregon" (R. 296).

By its decision in *Ah Pah Redwood Company* v. *Commissioner,* 251 F.2d 163, this Court remanded to the Tax Court for further decision as to whether the taxpayer in that case was holding certain timber primarily for sale to customers in the ordinary course of its trade or business. The articles of incorporation of the corporate taxpayer in that case stated that it was formed "to engage in the business of buying, selling, and owning timber and of carrying on a general logging and lumber business." The Tax Court also found that "this purpose included the manufacturing, selling, processing, and shipping of lumber and related products; the construction, ownership, and operation of sawmills,

tanbark mills, and pulp mills, as well as tramroads, railroads and steamships; and the acquisition, holding, improving, encumbering, developing, and exchanging of real and personal property of every kind." On remand, the Tax Court (TC Memo 1959-44) made the following ultimate finding:

> "Petitioner did not advertise the Sage timber for sale. It did not employ salesmen and it did not solicit offers from buyers. Nor did petitioner log or mill the Sage timber. It had no logging equipment and no sawmill and did not log timber or manufacture lumber during the taxable years.
>
> "Throughout the years 1948 and 1949 petitioner did not hold the Sage timber primarily for sale to customers in the ordinary course of its trade or business."

We respectfully submit that in the instant case there was no evidence of any holding of the properties for sale to customers in the ordinary course of business. The only way in which the petitioners could have been less active in the transactions would have been for them to have refused to make any sales whatsoever.

The taxpayers who were involved in the recent decision of the Court of Claims in *Scott et al* v. *United States* (1962), 305 F.2d 460, had made twenty-four purchases of timberlands in the State of Oregon, involving twenty-five tracts of timber, during the years 1944 through 1949 at a total cost of approximately $146,000. From 1944 through 1952, in fourteen transactions, the parties sold the twenty-five tracts for a total selling price in excess of $800,000. As in the instant case, the Commissioner of Internal Revenue took the position

that the timberlands were theretofore held by the taxpayers primarily for sale to customers in the ordinary course of business. In rejecting this contention by the Commissioner and deciding in favor of the taxpayers, the Court of Claims stated:

> "Obviously plaintiffs acquired this property for sale but we do not think they acquired or held property 'primarily for sale to customers in the ordinary course of his trade or business,' as stated in the statute. . . .
>
> "No one factor, obviously, is determinative of whether or not property is held primarily for sale to customers in the ordinary course of one's trade or business. But, among the factors regarded by the courts as important are the activities of the taxpayer, or his agents, in promoting sales, the extent of the development and improvement of the property, the purpose for which the property was acquired, and the frequency and continuity of sales."

Like the petitioners in the instant case, the Court of Claims found that no effort was made by the taxpayers to develop or improve the property, no roads were built to or on the timberlands, and no logging operations were ever conducted thereon by the parties. The Court then made the following significant observation:

> "The price of timber rose so rapidly after the war from 1946 until 1952 that it was possible to sell the timberlands at substantial profit after much shorter holding periods than was anticipated when the tracts were purchased. . . .
>
> "The average holding period for all the tracts purchased between 1944 and 1949 and sold between 1946 and 1952 was 34 months. Timberlands of the type purchased under the agreement between plain-

tiffs and McFadon were held by their owners for ten to twenty years or longer. However, the rapid rise in the price of timber after World War II made it possible to make profitable disposition of timberlands after shorter holding periods than had been anticipated when the earlier purchases had been made under the agreement. The profit realized from these sales by plaintiffs was not due to any business activity by plaintiffs; it resulted from this rapid rise in the price of timber which had been purchased as a capital asset investment, and not 'primarily for sale to customers in the ordinary course of (their) trade or business' as defined in the Internal Revenue Code of 1939, Section 117."

II.

In the alternative, the Tax Court erred in its interpretation of, and failure to apply, the provisions of Sections 117(k) and 117(j) of the Internal Revenue Code of 1939.

The intent of Congress to grant capital gains on timber by the 1943 enactment of Sec. 117(k) and the contemporaneous technical amendment of Sec. 117(j) of the Internal Revenue Code of 1939, appears from the following portion of Senate Report No. 627, 78th Congress, 1st Sess., pages 25-26:

> "*In short, if the taxpayer cuts his own timber, he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another.* Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are, therefore, not accorded under present law capital gains treatment of any increase in value realized over the depletion basis.

"In order to remedy this situation, it is proposed to amend the existing law, as follows:

* * * * *

"If an owner of timber disposes of it under a contract by virtue of which he retains an economic interest in such timber, the amount received by such owner is to be treated in a similar manner." (i.e. as a gain or loss upon the sale of the timber.)

"This latter provision will afford relief to those who have leased their property under a contract whereby they retain an economic interest in the timber and are not entitled under the present law to capital gains treatment *because of that fact.*" (Emphasis supplied)

Section 117(j), as amended in 1943, provided capital gains treatment on net gains from the sale of real or depreciable property used in the trade or business of the taxpayer and held for over six months. While the term "property used in the trade or business" excludes property held by the taxpayer primarily for the sale to customers in the ordinary course of his trade or business, such term (by the 1943 amendment) includes timber, with respect to which Subsection (k)(1) or (k)(2) applies, without any exclusion for property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Respondent should agree that Section 117(j) grants capital gains on sales of timber, with respect to which Subsection (k) applies, regardless of the nature of the taxpayer's business. Petitioners contend that Section 117(k) applies to their timber sales, whether or not an economic interest was retained. Subsection (k)(2) only provides that a disposal of timber held for more than

six months, with an economic interest retained, shall be considered as though it were a sale of such timber, and Section 117(j) provides capital gains for timber to which Section 117(k) applies. Subsection (k) uses the word "sale", as well as the term "disposal with an economic interest retained". When considering this statute along with the Senate Finance Committee report at the time of its adoption, it appears that Congress intended to put disposals of timber with an economic interest retained in exactly the same category as sales of timber. There is, however, nothing to indicate that Congress intended to give an advantage to taxpayers disposing of timber with an economic interest retained, as compared to taxpayers who sell their timber outright.

It will be noted that the petitioners made other sales of timber during the taxable years (Appendix B) but retained an economic interest therein, thus qualifying for capital gains treatment under Section 117(k)(2). The respondent does not question this. Respondent's theory seems to be that one can make thousands of disposals with an economic interest retained and receive capital gains, whereas if he makes a few real sales, Section 117(k) is not applicable.

Literally, a disposal with an economic interest retained is not a sale, but Congress provided in Section 117(k) that it would be considered as though it were a sale. It is unlikely that Congress intended to grant capital gains on disposals with an economic interest retained and deny capital gains for actual sales.

If Congress intended to provide capital gains only

to taxpayers who were not dealers and who either cut their own timber or disposed of the same by contract under which they retained an economic interest, then the addition of Section 117(k) to the Internal Revenue Code of 1939, without any amendment to Section 117(j), would have clearly accomplished this purpose. Then gains to anyone who disposed of timber, whether by outright sale, by cutting his own or by contract by which he retained an economic interest, would be determined to be capital gains or ordinary income under Section 117(a). However, Congress went further and amended Section 117(j) granting capital gains on all gains from disposals of timber to which Section 117(k) applies, regardless of the nature of the taxpayer's business or the purpose for which the timber was held.

Petitioner's interpretation of Section 117(j) and (k), together, is that Section 117(k) merely enlarged the word "sale" to include dispositions that otherwise would not be sales, and that Section 117(j) granted capital gains on sales of timber under the enlarged definition of the word "sales". Therefore, petitioners submit, in the alternative, that they were entitled to capital gains treatment of the proceeds from all timber sales, whether they held the timber for investment, as they contend, or for sale, as respondent contends.

III.

The Tax Court erred in its failure to apply the provisions of Section 112(b)(1) of the Internal Revenue Code of 1939 to certain exchanges during the taxable years of like properties.

The 1950 transaction with Wrenn Planing Mill (R. 103-4), the 1951 transaction with Monroe Lumber Co. (R. 107-110), the 1952 transaction with Springfield Plywood Co. (R. 111-113), and the 1953 transaction with Pritzlaff and Wilson (R. 113-121) each qualified as a nontaxable exchange of like properties, within the purview of Section 112(b)(1) of the 1939 Internal Revenue Code, except to the extent of boot received in such exchanges, which boot was duly recorded by petitioners on the returns filed by them for the respective years (Exs. 1-A, 2-B, 3-C, 4-D).

Section 112(b)(1) of the Internal Revenue Code of 1939, applicable to the tax years in question, provided as follows:

> "Property held for productive use or investment—no gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

The Tax Court did not determine that these were not, in fact, true exchanges of properties of "like kind". The Tax Court stated:

> "We have held that petitioner's timber, in each of the years here involved, was held by him primarily for sale to customers in the ordinary course of

his trade or business and not for investment. Therefore, since the property transferred by petitioner was not held by him for productive use in his trade or business or for investment, the transactions result in recognizable gains. Cf. *Regals Realty Co.* v. *Commissioner,* 127 F.2d 931 (C.A.2, 1942) affirming BTA 194 (1940).

"It is, therefore, unnecessary to pass upon other contentions made by respondent. We sustain respondent's determination with respect to each of the claimed exchanges." (R. 174)

This issue is directly related, therefore, to the primary issue as to whether or not the specific tracts of timber sold or exchanged by petitioners during the taxable years were theretofore held primarily for sale to customers in the ordinary course of business. Petitioners respectfully request that, if this Court finds that petitioners are entitled to prevail on the primary issue, the case be remanded to the Tax Court for a further determination as to whether or not these were, in fact, true exchanges of like properties, within the purview of Section 112(b)(1) of the Internal Revenue Code of 1939.

IV.

The Tax Court erred in its interpretation of the contract between petitioners and one J. L. Ledgett and erred in failing to apply the provisions of Section 117(k)(2) of the Internal Revenue Code of 1939 thereto.

On November 10, 1952, petitioner William J. Wineberg entered into an agreement with one J. L. Ledgett (R. 122-125, Ex. 10-J) under the terms of which petitioner

sold to Ledgett for $30,000 all of the merchantable timber on certain real property owned by petitioners in Linn County, Oregon. Petitioners received a $5,000 payment on the purchase price upon execution of the contract, and the balance of $25,000 was paid to them during the year 1953 (R. 122). The agreement is set forth on pages 122 to 124, inclusive, of the transcript of the record.

As the agreement indicates, the balance of the purchase price was payable by the purchaser, J. L. Ledgett, at the rate of $20 per M for all saw logs removed from the tract and at the rate of $35 per M for all peeler logs removed from the tract, with petitioners retaining an economic interest in the timber until the purchase price was paid.

For the reasons stated under section I of the Argument herein, petitioners contend that the property in question was not held by them theretofore primarily for sale to customers in the ordinary course of business, but in the alternative, petitioners contend that the contract with J. L. Ledgett provided for the retention by the petitioners of an economic interest in said timber, thus qualifying for the treatment of the proceeds therefrom in accordance with the provisions of Section 117(k)(2) of the Internal Revenue Code of 1939.

An examination of the agreement (R. 122-124 (Ex. 10-J) reveals the fact that this was a "pay-as-cut" contract in which the petitioners retained an economic interest in the timber within the purview of the code section referred to above. Particular reference should be

made to paragraph 10 (R. 124) of the agreement with Ledgett in which the petitioners reserve the right to cancel the rights of the purchaser in the event of any default in the making of the payments.

It is recognized by this Court, *Ah Pah Redwood Co.* v. *Commissioner,* 251 F.2d 163, and by respondent (Rev. Rul. 57-90, 1957-1 CB 199) that if a taxpayer otherwise conforms to the requirements of Section 117(k)(2), he is entitled to capital gains treatment thereunder, notwithstanding that he was holding the timber disposed of primarily for sale to customers in the ordinary course of business.

We submit that an examination of the agreement will show that the petitioners had, in fact, retained an economic interest therein within the purview of this code section. The balance of the purchase price was to be paid by J. L. Ledgett as he sold the logs and, because of the financial condition of Ledgett (R. 239), petitioners believed that he could not pay for the timber until he cut the same and sold the logs. Contrary to the conclusion of Judge Scott (R. 179) petitioners were dependent upon the severance and sale of the timber for a return of their investment. Petitioners were, of necessity, looking to the cutting of this timber for the payment of the purchase price (R. 239), and the retention by the petitioners of an economic interest in said timber appears to be self-evident.

It is submitted that this transaction is entitled to capital gains treatment.

V.

The Tax Court erred in determining that certain "production royalties" received by petitioners during the years 1951, 1952 and 1953 constituted ordinary income to petitioners rather than long term capital gains.

On July 5, 1951, petitioners entered into an agreement with Cascadia Lumber Company (R. 126-133, Ex. 54), providing for the sale by petitioners to Cascadia Lumber Company of certain timber then owned by petitioners. The purchase price to be paid to petitioners was computed on a basis of certain dollar amounts per thousand board feet of such timber, and the agreement also provided that the purchaser of the timber would pay to petitioners the additional sum of 75¢ per thousand board feet for all lumber manufactured at the mill of Cascadia Lumber Company. On the same day, petitioner William J. Wineberg entered into a related and similar agreement with Yaquina Bay Mills, Inc. (Ex. 55), by the terms of which that corporation agreed, inter alia, to pay to petitioners additional sums equal to 75¢ per thousand board feet on all lumber surfaced or processed at the plant of said corporation.

During the years 1951 to 1953, inclusive, petitioners received the following amounts (which were determined by the quantity of lumber manufactured in the sawmill of Cascadia Lumber Company or surfaced in the planing and remanufacturing mill of Yaquina Bay Mills, Inc., as stated in the preceding paragraph) which were inadvertently and erroneously reported on the petition-

ers' income tax returns filed for said years as ordinary income "production royalties", rather than as long term capital gains;

Year	Amount
1951	$ 9,008.15
1952	15,314.76
1953	17,774.55

(R. 133, Exs 2-B, 3-C, 4-D)

The facts relating to to this item are set forth more fully in the record at pages 126 to 133, inclusive.

By appropriate amendments to their petition to the Tax Court filed by petitioners at the close of the hearing, petitioners alleged that the amounts stated above should have been reported by them as long term capital gains, and their taxable income for such years should have been reduced accordingly.

Examination of the agreement (Ex. 54) reveals the fact that this was a "pay-as-cut" contract in which the petitioners retained an economic interest in the timber, within the purview of Section 117(k)(2) of the Internal Revenue Code of 1939. As this Court stated, in *Ah Pah Redwood Co.* v. *Commissioner,* 251 F.2d 163:

> "A taxpayer is entitled to capital-gains treatment of income derived from the disposal of timber under Section 117(k)(2), without regard to the purpose for which the timber was held, provided the taxpayer satisfies the other requirements set forth in the cited statutes."

A further examination of these two agreements (Exs. 54 and 55) shows that these so-called "production royalties" were, in fact, additional amounts being paid to petitioners for their timber (R. 128). Respondent has

not questioned the right of petitioners to capital gains treatment of the other proceeds from the timber. It would appear, therefore, that the so-called "production royalties" from Cascadia Lumber Company and Yaquina Bay Mills, Inc., received by petitioners pursuant to the terms of these agreements were entitled to capital gains treatment just as were the amounts received directly for the sale of the timber, whether or not the petitioner William J. Wineberg was a "dealer", as contended by respondent.

VI.

The Tax Court erred in determining that petitioners did not sustain a short term capital loss of $10,000 from the sale of certain shares of stock of Yaquina Bay Mills, Inc. in the year 1951.

The evidence relating to the disposition of petitioners' shares of stock of Yaquina Bay Mills, Inc. is set forth in detail on pages 137 to 151 of the transcript of the record. The contentions by the respondent in the court below, that petitioners' claimed basis for the stock was understated and that they did not have the requisite six months holding period prior to disposition thereof, were determined against respondent by the Tax Court and are no longer in controversy.

The petitioners contend, however, that the Tax Court erred in failing to find (R. 189-191) that they sustained a short term capital loss on the disposition in 1953 of the remaining 675 shares of such stock. The parties are agreed that the cost basis to petitioners was

$81,000. It is petitioners' contention that the selling price of certificate No. 5 for 675 shares was $71,000. This is exactly what the agreement between George F. Miller Lumber Co. and petitioner (Ex. 39-MM) says. The Tax Court, however, refused to give effect to the purchase price allocation. (R. 190) Respondent called Mr. George E. Miller as a witness, who testified:

> "Well, there were weeks or months of negotiations and it wasn't just a deal overnight. It was sort of a complicated deal but the paper that we signed would have to confirm just what it is." (R. 408)

Unless the agreement between these unrelated parties is ignored, the tax consequences of the sale of the 1350 shares of Yaquina Bay Mills, Inc. by petitioners in 1951 should be as follows:

Date Acquired	Date Sold	No. Shares	Cost	Selling Prices	Profit or Loss
6/50	3/51	375	$ 33,333.75	$ 52,500.00	$19,166.25
6/50	5/51	300	29,166.25	101,500.00	72,333.75
3/51	5/51	675	81,000.00	71,000.00	(10,000.00)
		1350	$143,500.00	$225,000.00	$81,500.00

Petitioners submit that they sustained a short term capital loss of $10,000, in addition to the long term capital gains as indicated above.

VII.

The Tax Court erred in determining that an amount received by petitioners in 1950 for use of a logging road constituted ordinary rental income to petitioners rather than long term capital gain from the grant of an easement.

In 1944, petitioner William J. Wineberg had acquired certain timberlands in Lincoln County, Oregon, which were the subject of a contract of February 10, 1950 (R. 136, Ex. 8-H) with Monroe Lumber Company. Under the terms of that contract, Monroe Lumber Company agreed to pay to petitioner the sum of $4,000 for logging roads theretofore constructed by a previous contract purchaser of the property which had defaulted on its contract (R. 136). The $4,000 received by petitioners for the sale of such improvements to Monroe Lumber Company was reported on their 1950 income tax return (Ex. 1-A) as a long-term gain from the sale of a capital asset and did not represent "road rentals" as determined by the Tax Court. Petitioners respectfully submit that the agreement shows that petitioners granted an easement to Monroe Lumber Company and that the proceeds from the grant of such an easement are entitled to capital gains treatment.

The pertinent parts of the agreement of February 10 1950, between petitioner and Monroe Lumber Co. (Ex. 8-H) are as follows:

> "2. The *seller hereby gives and grants to the buyer,* his agents and servants, *the right, privilege and easement* to enter upon said lands to log, cut and remove said timber

therefrom and to place and install upon said lands whatever equipment and machinery may be necessary to conveniently log said timber and to harvest, process logs from said lands. Said rights and easements to terminate upon the complete removal of said timber or upon the termination or cancellation of this contract as hereinafter provided. (Emphasis supplied.) . . .

"10. The buyer agrees to pay the seller upon demand the sum of Four Thousand ($4,000.00) Dollars as compensation for roads established by the seller and roadwork performed by the seller, buyer to have the unrestricted use of such roads during the life of this contract."

The uncontradicted testimony of petitioner William J. Wineberg on this transaction is to be found on pages 223 to 227, inclusive, of the Transcript of Record.

Under the applicable law, an easement constitutes an interest in land. *Steelhammer* v. *Clackamas County,* 170 Or. 505, 135 P.2d 292. The grantee of an easement is the "owner" of the incorporeal interest created by the grant. *Oregon* v. *The California-Oregon Power Company,* 225 Or. 604, 358 P.2d 524.

As the respondent has stated in his own Revenue Ruling 59-121, 1959-1 CB 212:

> "The consideration received for the granting of an easement with respect to land constitutes the proceeds from the sale of an interest in real property. The amount received should be applied as a reduction of the cost or other basis of the land subject to the easement. Any excess over basis constitutes recognized gain."

When respondent determined that the $4,000 re-

ceived by petitioners "as compensation for use of roads", he would appear to be attempting to rewrite paragraph 10 of the February 10, 1950 agreement to read:

> ". . . as compensation for (the use of) roads established by the seller . . ."

It is submitted that the agreement in question provided in part for the granting of an easement to Monroe Lumber Co. and that the proceeds from the granting of such easement were properly reported as a long-term capital gain by petitioners in the year 1950.

VIII.

Petitioners were entitled to a $5,000 charitable contribution deduction in the year 1953 for that amount paid by them to the Sacred Heart Church.

On January 8, 1953, petitioner William J. Wineberg issued his check in the amount of $5,000 as a contribution to the Sacred Heart Church at Newport, Oregon, (R. 151-2, Ex. 34-HH) and such contribution was properly claimed as a charitable or religious contribution on the income tax return filed by petitioners for the year 1953 (Ex. 4-D).

In the original deficiency notice issued by respondent on November 10, 1958, this claimed charitable contribution was not disallowed. It was only at the time of the trial several years later that the respondent filed an amended answer (R. 49) alleging for the first time that this $5,000 was not a charitable contribution, as claimed, but was a nondeductible capital expenditure.

Rule 32 of the Rules of Practice of the Tax Court (adopted pursuant to Sec. 7453 of the Internal Revenue Code of 1954) provides that the burden of proof on such new matter was on the respondent.

The testimony and other evidence on this issue was somewhat conflicting and confusing. Petitioner William J. Wineberg testified (R. 383-4) that this was a bona fide contribution, although he was not a member of that church. It is readily apparent that the contribution was made for the primary purpose of ingratiating himself with the pastor of the church so as to have an opportunity to bid on certain timber which the pastor controlled and land which the church had inherited. It is also readily apparent, however, that the $5,000 was paid to the church without any contingency; i.e., had petitioner not been the successful bidder for the land and timber, the $5,000 would have been retained by the church.

Respondent offered the testimony of a Father Rodakowski, the pastor of the church. In answer to a leading question from respondent's counsel, the pastor did affirm that two checks, totaling $18,000, were in payment for the timber and the land (R. 414). On the other hand, this witness of respondent also testified regarding his conversations with petitioner William J. Wineberg relating thereto and stated, "I told him, too, that I had wanted at least $5,000 somewheres, and he had promised me at that time that if he had a chance at the timber and the land he would see that I would get my $5,000 as a contribution of some sort to the church."

Because, as the pastor testified, petitioner had "made a contribution to the church" (R. 414), the timber was sold to him rather than to others. The pastor had previously spoken to petitioner about his making a contribution to the church in order to assist him in building his school (R. 418). The pastor estimated that the value of the timber which belonged to the heirs of the estate was $12,000 (R. 419). Of the $18,000 received by the church and the heirs of the decedent's estate during this period of time, $12,000 was paid to the heirs, and the church retained the balance of $6,000 (R. 418-9), with $5,000 representing the contribution by the petitioner and the remaining $1,000 representing the agreed value of the land (Ex. 25-Y) which was devised to the church by the decedent Peter J. Maesfrancx. At another point in his testimony the pastor indicated that others had offered $17,000 for the land and timber and that petitioner's representatives had replied, "Well, we'll give eighteen thousand." (R. 414). Documentary stamps in the aggregate amount of $14.30 (indicating the total consideration for the land and timber was $13,000—not $18,000) were affixed to the deeds (Exs. 22-V and 23-W). Since respondent had the burden of proof on this issue, the confusion on this point should have been resolved against him.

The Tax Court, citing only the *Estate of O. J. Wardwell,* 35 T.C. 433, decided that the deduction was not allowable because it was "in fact, paid for some personal benefit" (R. 191). Since the decision of the Tax Court in this case, however, the Court of Appeals for the Eighth Circuit has reversed the Tax Court and found

in favor of the taxpayer in that case. *Estate of O. J. Wardwell* v. *Commissioner,* 301 F.2d 632.

In the *Wardwell* case, the taxpayer had made a "contribution" of $7,500 to a charitable institution as a room endowment. The Tax Court had disallowed the deduction because the payment was made in anticipation of reduced charges and to secure room occupancy and, thus, made in anticipation of benefits of an economic nature. The Court of Appeals, however, held that the Tax Court had confused "motive" and "expectation" with "legal rights and consideration" and that the pledge of the funds was absolute and unconditional. The claimed deduction was allowed. The appellate court approved the dissenting opinion of Tax Court Judge Pierce, who stated:

> "Many charitable gifts, and particularly those made to local charities, yield benefits to the donor; and the existence of absolute purism in a donor's motive for making a charitable gift, is not commonly regarded to be material . . .
>
> "Moreover, solicitation of charitable gifts are frequently accompanied by a statement that they will qualify for income tax deduction by the donor, and with the further suggestion that the income tax benefits may be increased, if property or securities which have appreciated in value are given in kind. In the recent case of *Maysteel Products, Inc.,* 33 T.C. 1021, this Court upheld for deduction under the statute, gifts to charities which had been made as part of a scheme of the donors to obtain tax benefits.
>
> "Congress made provision for the deduction for charitable gifts, in order to induce and encourage the making of such gifts. See S. Rept. No. 1567, 75th Cong., 3d Sess., reprinted in 1939-1 C.B. (Part

> 2) 779, 789. And this Court has held that, "Tax provisions as to charities are begotten from motives of public policy and are not to be narrowly construed.' *Estate of J. B. Whitehead,* 3 T.C. 40, afd. 147 F.2d 977; *Helvering* v. *Bliss,* 293 U.S. 144. I believe that in applying such provisions the donor's motive for making the charitable gift is immaterial."

It is submitted that the Tax Court erred in disallowing this deduction because petitioner received some personal benefit therefrom.

CONCLUSION

Petitioners respectfully submit that Judge Scott erred in her interpretation and application of the phrase "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" found in Section 117(a)(1) of the Internal Revenue Code of 1939, defining "capital assets", and erred in reclassifying the proceeds from the sale of timber which had been held by petitioners for many years prior thereto.

For the reasons heretofore stated, petitioners also submit that Judge Scott erred in deciding certain subsidiary issues in favor of the respondent.

The judgment of the Tax Court should be reversed and remanded to the lower court for the purpose of determining whether the transactions referred to in Section III of the Argument herein were qualifying exchanges of like properties within the purview of Section 112(b)(1) of the Internal Revenue Code of 1939.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

(sgd.) CHARLES P. DUFFY
Of Attorneys for Petitioners

APPENDIX A

Summary of Timber Sales in Question

Year	Purchaser	Year of Acquisition	Sales Price	Cost	Profit
1950	Stebco Lumber Co.	1942	$ 26,253.25	$ 340.00	$ 25,913.25
	Columbia Hudson Lbr. Co.	1943	14,873.50	190.80	14,682.70
	A. J. Gross	1937	500.00	186.00	314.00
	Maloney & Lee Chambers	1941	2,700.00	100.00	2,600.00
	A. K. Wilson	1942	2,000.00	unknown†	2,000.00
	Monroe Lumber Co.				
1951	Wagner Bros. Lumber Co.	1940	13,000.00	72.00	12,928.00
	Sherman Hendrickson	1943-6	9,700.00	unknown†	9,700.00
	Downing	1944-5	1,311.62*	unknown†	1,311.62
	Graff	1946	4,170.93*	200.00	3,970.93
	Multnomah Plywood	1942	2,212.70	unknown†	2,212.70
	P & W	1943-6	4,541.65	unknown†	4,541.65
	Hogan	1939	5,020.00*	2,218.00	2,802.00
	Weinert	1944	4,690.00	unknown†	4,690.00
	Landess	1943	3,750.00	unknown†	3,750.00
1952	J. L. Ledgett				
	Peninsula Plywood	1946	1,000.00	27.17	972.83
	Swanberg	1942	1,100.00	129.00	971.00
	Morris	1936	4,650.00	180.00	4,470.00
	Ermanson	1944	3,000.00*	189.00	2,811.00
	Rice Brothers	1950	2,000.00	750.00	1,250.00
1953	Beckman	1951	1,750.00*	62.50	1,687.50
	Guy Roberts Lumber Co.	1951-2	15,938.97	8,500.00	7,438.97
	Swanberg	1946	2,000.00	unknown†	2,000.00
	Dollar & Patterson, Inc.				
	Northern Lumber Co.	1944	4,879.00	329.18	4,549.82
	Harbor Lumber Co.	1946	3,050.25*	220.00	2,830.25
			$134,091.87	$13,693.65	$120,398.22

* Involuntary sale caused by unauthorized trespass.

† No basis claimed by petitioners—entire profit reported on income tax return (R. 93, 96, 214-257).

No. 18210 and No. 18211

United States Court of Appeals
For the Ninth Circuit

No. 18210

BERNICE CLEFF, a single woman, *Appellant,*

vs.

NORTHERN PACIFIC RAILWAY CO., a foreign corporation, d/b in the State of Washington, *Appellee.*

No. 18211

ADA KNIGHT, a widow, *Appellant,*

vs.

NORTHERN PACIFIC RAILWAY CO., a foreign corporation, d/b in the State of Washington, *Appellee.*

UPON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON SOUTHERN DIVISION

BRIEF OF APPELLEE

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INDEX

TABLE OF CASES

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UPON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON
SOUTHERN DIVISION

BRIEF OF APPELLEE

JURISDICTION

(Transcript references: R.—Vol. 1, R.-2—Vol. 2.)

DISTRICT COURT—This action was commenced in the United States District Court for the Western District of Washington, Southern Division, by the filing of separate complaints. Appellant Cleff is a citizen of the State of Oregon, appellant Knight a citizen of the State of Washington, and the defendant Railway Company is a foreign corporation authorized to do and doing

business as a common carrier within the State of Washington and within the Western District of Washington. The jurisdiction of the District Court is based upon diversity of citizenship under 28 U.S.C., Sec. 1332, and the amount in controversy in each claim exceeds the sum of $10,000. The foregoing facts appear in the pre-trial orders entered in each case (R. 9, 16). The cases were consolidated for trial (R. 5, 6), and came on for trial on June 12, 1962. On that day, appellants rested their case in chief insofar as producing evidence regarding liability was concerned (R.-2, 95).

Appellee then moved for an order of involuntary non-suit and for entry of judgment of dismissal with prejudice in each case, based upon the fact that appellants had produced insufficient evidence to make a question of fact for the jury as to any negligence on the part of appellee proximately causing or contributing to appellants' injuries (R.-2, 96). After argument, these motions were granted (R.-2, 111), and subsequently the orders granting the motions and judgment of dismissal with prejudice were entered herein (R. 11, 28; R. 12, 29). Appellants gave timely notice of appeal (R. 13, 30), and thereafter the cases were consolidated for the purpose of appeal (R. 36).

COURT OF APPEALS—This appeal to the United States Court of Appeals for the Ninth Circuit is from a final decision of the United States District Court for the Western District of Washington, Southern Division which District Court is in the Ninth Circuit. Under Title 28, Chapter 83, U.S.C. 1291 and 1294 (a), such decision is properly reviewable by such Court of Appeals.

COUNTER-STATEMENT OF THE CASE

Appellants state, on page 3 of their Brief, that at the time of the accident the sun was shining brightly in the eyes of westbound drivers (R. 9, 16; R.-2, 3, 31, 68, 88), which affected the vision of westbound drivers straight ahead. At the trial of this case, the drivers of the two westbound cars approaching the scene of the accident testified as follows regarding the effect of the sun on their view of the train movement in question:

Witness Willard Harold Sherwood testified on direct examination as follows:

> "Q. As you were approaching the railroad crossing at the St. Paul Mill was this [the sun] having any effect upon your ability to observe things ahead or to either side?
>
> A. There was a great deal of reflection on the surrounding buildings and windows causing visibility to be rather difficult." (R.-2, 3, 4)

The above response of witness Sherwood is not evidence that the sun affected his vision of the train movement on the crossing. On cross-examination regarding the effect of the sun on his view of the train, witness Sherwood testified as follows:

> "Q. Were these two visions, the flagman and the train one right after another practically at the same time?
>
> A. Yes. The flagman, he was walking ahead of the train. I couldn't say how far, but I am sure he was.
>
> Q. Now, how far back from the crossing were you?
>
> A. Oh, fifty to sixty feet, I would say.

Q. All right. Now, at that point was the sun interfering with your view of this train?

A. Not so much then, but just prior to that there had been a blinding blast of sun as you passed buildings.

Q. But as you sit here this morning telling us about what happened many, many months ago, your best recollection is that the sun did not interfere with your vision of the train once you saw it on the street, is that correct?

A. That is correct, once I got that close, I would say that." (R.-2, 15, 16)

The other westbound driver, Virginia Warren, in whose car appellants were riding at the time of the accident, testified as follows regarding the effect of the sun on her view:

"Q. As you crossed the Canal Street Bridge there and approached these railroad tracks, will you tell us, was there anything impeding your vision, your ability to see ahead?

A. There wasn't.

Q. Was there any atmospheric condition causing you any difficulty?

A. No.

Q. How about the sun?

A. No, the sun—I pulled my visor down over, you know, and it was real bright, but that didn't interfere." (R.-2, 31)

By way of pre-trial order, the following facts were admitted by the parties hereto:

That the accident in question occurred on December 22, 1958, at about 3:45 p.m., at a railroad grade cross-

ing of the St. Paul Mill tracks on 11th Street in the city of Tacoma, Washington; that the weather was clear and dry and the sun was shining brightly at the time; that 11th Street is a four-lane street with two lanes of traffic in each direction; that, at the time, a traffic signal consisting of a red light was in place over the crossing approximately in the middle of the street; that before the train started to enter the street, the red overhead traffic signal was manually actuated by a member of the train crew; that, after this was accomplished, a signal was given for the train to proceed; that, upon the train's commencing to move, two switchmen preceded the train into the street and by manual signals stopped both lanes of eastbound traffic on 11th Street; that the switchmen then proceeded to the center of 11th Street, at which time the leading end of the train was at or near the southerly edge of 11th Street; that, at about this time, the vehicle traveling west in the inside lane of 11th Street was brought to a stop; that, after the train crew had stopped the westbound car in the inside lane on 11th Street, the car in which appellants were riding overtook and passed the stopped car and collided with the train (R. 9, 16).

Mr. Sherwood, the driver of the westbound automobile traveling in the inside or center lane on 11th Street, that was brought to a stop by the train crew, testified as a witness on the trial of this case. Witness Sherwood approached the crossing at a speed of approximately 25 miles per hour (R.-2, 4), and saw the flagman on the crossing waving him to a stop when his automobile was probably 50 feet from the crossing (R.-2, 5). The flagman was standing about in the center of 11th Street

at the crossing at this time (R.-2, 5). Mr. Sherwood saw the flagman in plenty of time to bring his car to a stop rather easily, about 30 feet from the track which the train was upon (R.-2, 6). Mr. Sherwood then saw the flagman proceed into his lane of traffic, and saw him desperately try to attract the attention of Virginia Warren, driver of the vehicle in which appellants were riding (R.-2, 7), and further testified that the flagman was waving his arms at the Warren vehicle at the time the Warren car was 70 feet to the rear of the stopped Sherwood vehicle (R.-2, 17). Sherwood, after stopping, looked back toward the Warren vehicle, as he thought possibly they might not see the approaching train (R.-2, 7, 8), because at the time he passed their car upon his approach to the crossing, the women were visiting in the car and he thought that because of their visiting they might not be alert to the flagman or the light (R.-2, 18). At the time he looked to the rear upon bringing his car to a stop, the Warren vehicle was roughly 70 to 100 feet east of his car (R. 2, 8) and the leading end of the train was over 10 feet onto the traveled portion of 11th Street (R.-2, 14). Mr. Sherwood testified that the logs on the train were piled to a height of 25 feet from the street (R.-2, 16).

Virginia Warren, the driver of the car in which appellants were riding, also testified at the trial of this matter. Mrs. Warren testified that she first saw the train when the front of her car was 6 feet from the point of impact (R.-2, 33), at which time the leading end of the train was 10 feet from the point of impact (R.-2, 33), and at that time she applied the brakes of her vehicle and brought it to a stop foul of the track

on which the train was approaching (R.-2, 34), and the collision then occurred. Mrs. Warren testified that she was familiar with the crossing and the fact that trains used it, and that she had stopped for trains using this crossing, on previous occasions, a number of times (R.-2, 34). Mrs. Warren further testified that the logs on the train were considerably higher than her car and considerably higher than the car driven by Mr. Sherwood (R.-2, 39), and that there was nothing to obstruct her view of the train or the logs as she approached the crossing (R.-2, 39); that she first looked for approaching trains when her vehicle was 15 to 20 feet from the crossing, at which time she had passed the Sherwood vehicle (R.-2, 41). Mrs. Warren testified as follows regarding her view of the train:

"Q. But is there anything that would have obstructed your view of this train as you approached that crossing from the time that it entered the street, the train entered the street—was there anything that would have obstructed your view had you looked in that direction?

A. No, not at that point I guess there wasn't." (R.-2, 43)

"Q. Mrs. Warren, let me ask you one other question; on December 22, 1958, at about 3:45 p.m. in the afternoon, did you approach that crossing as if you had been looking for a train—if you had actually looked on the crossing for a train, there is no reason why you couldn't have seen that train and brought your car to a stop, isn't that correct?

A. Yes, but I relied on those—

THE COURT: But your answer is yes, you say?

THE WITNESS: Yes.

THE COURT: All right.

MR. ALLERDICE: That is all the questions I have." (R.-2, 51, 52)

Appellant Cleff, at the trial of the case, testified that she was riding in the back seat of the Warren vehicle (R.-2, 66); that she saw the train come out from behind a building on the south edge of 11th Street, at which point the Warren vehicle was 100 feet from the crossing (R.-2, 67); that, after seeing the train, she sat there for a few minutes and then finally called to the driver, Mrs. Warren, to call her attention to the approaching train (R.-2, 68); that the train was quite near the point of impact when she called to Mrs. Warren, and that she did not bring to Mrs. Warren's attention the presence of the approaching train sooner because she thought Mrs. Warren would stop the car (R. 2, 68, 69). The sun did not bother Mrs. Cleff insofar as her view of the train was concerned (R.-2, 81, 82). There was no obstruction to her view of the train (R.-2, 82). Mrs. Cleff had on previous occasions noticed the red signal at the crossing, but just didn't look up at it on the day in question (R.-2, 82). Appellant Cleff testified that she saw no flagman on the crossing, but explained the reason was because she was not looking in that direction. As the following testimony points out, she was watching the train:

"THE COURT: Mrs. Cleff, did you watch the train the whole time as it came, continued to approach?

THE WITNESS: I watch the train?

THE COURT: The whole time, saw it moving out there all the way across?

THE WITNESS: Well, I was just sitting there riding, and I glanced at her—

THE COURT: When you said you were watching the train — that is what I was wondering — you watched it all the way as it came from over here way on the other side of the street and all the way across?

THE WITNESS: Well, I don't just really know exactly.

THE COURT: Whether you were watching all the time, but most of the time?

THE WITNESS: I think so.

THE COURT: It was perfectly plain to see the train if you looked for it?

THE WITNESS: Yes, I know it didn't take long.

Q. (By Mr. Allerdice) At the time you first saw the train, you had no concern as far as any accident was concerned, is that correct?

A. No.

Q. Why was that?

A. Well, I wasn't—I thought that she would stop, and I wasn't thinking about an accident." (R.-2, 84, 85)

Appellant Knight was taking off her overshoes and did not see the train upon approaching the crossing, as, for some distance from the crossing to the point of impact, she was not looking out of the car (R.-2, 88).

SUMMARY OF ARGUMENT

The sole question raised by this appeal is whether or not appellants produced sufficient evidence on their case in chief to raise a question of fact for the jury as

to whether or not the Railway Company breached any duty owing to appellants, and if so, whether such breach proximately caused or contributed to the accident.

It is appellee's position that it complied with all duties owing to the appellants and that the sole proximate cause of the accident was the negligence of the driver of the automobile in which appellants were riding, in conjunction with the negligence of appellant Cleff.

ARGUMENT

The statutes of the State of Washington, setting forth the standard of care to be exercised by the operators of motor vehicles approaching public railroad grade crossings, are as follows:

> "46.60.300 *Stopping at railroad crossing or movable span at signal.* Whenever any person operating a vehicle approaching any railroad grade crossing or structure with a movable span and a clearly visible electrical, mechanical or manual signal device is in operation and gives warning of the immediate approach of any train or operation of movable span, the operator of such vehicle shall stop within fifty feet, unless vehicles ahead require a greater distance, but not less than twenty feet, from such railroad or span and shall not proceed until he can do so safely. The operator of any vehicle shall stop his vehicle and remain standing and not traverse any railroad grade crossing or structure when crossing gate is lowered or when a human flagman or mechanical or electrical signal gives or continues to give a signal of the approach or passage of any train or movement of the span [1961 c. 12 § 46.60.300. Prior: 1937 c. 189 § 102 RRS § 6360-102.]"

"46.60.320 *Stopping or reducing speed at other grade crossings.* . . . Any person operating a vehicle, . . . shall, upon approaching the intersection of any public highway with a railroad or interurban grade crossing, reduce the speed of his vehicle to a rate of speed not to exceed that at which, considering the view along the track in both directions, the vehicle can be brought to a complete stop not less than ten feet from the nearest track in the event of an approaching train. . . . "

In addition to the above statutes, the standard of care and the duty of the operator of a motor vehicle approaching a grade crossing are promulgated as follows in the case of *Haaga v. Saginaw Logging Company,* 169 Wash. 547, 549, 14 P.(2d) 55:

"We have repeatedly stated that the general rule regarding the standard of care to be exercised by those traveling upon a highway is that they must exercise a reasonable care under the existing circumstances. We have, in many of our decisions, given judicial expression to what is commonly and currently accepted as a well-known fact, *i.e.,* that a railroad crossing is a proclamation of danger, and that those who propose to enter its zone must govern themselves accordingly.

"Recognizing this principle, we have added to the usual rule of 'reasonable care under the circumstances,' the specific requirement that the traveler approaching a railroad crossing must look and listen. Accompanying this statement of the rule is the added requirement that the observation must be made at a point or from a position where it would be effective. [Citing cases.]"

Where any condition exists which tends to obscure the vision of the operator of a vehicle knowingly ap-

proaching a railroad grade crossing, the law imposes an increased duty on the part of the operator. The case of *Morris v. Chicago, M. St. P. & P. R. Co.,* 1 Wn.(2d) 587, 597-8, 97 P.(2d) 119, adheres to the general rule placing this greater degree of care upon one approaching a crossing. The degree of care required is in proportion to the conditions prevailing which limit the determination and observation of danger from approaching trains. The cited case involved the death of the driver of a truck at a railroad grade crossing. There was evidence to the effect that the reason the truck driver failed to see the approaching train was that the load of hay on the track restricted his vision in the direction of the train. The plaintiff contended that because the hay on the truck was a lawful load, even though it obstructed all view to the rear, deceased was not negligent in not seeing the train, and although the court stated that the deceased's view was obstructed because of a condition for which he, himself, was responsible, the rule set out would be applicable to the factual situation in question here. The court states:

> "In *McFadden v. Northern Pac. R. Co.,* 157 Wash. 437, 289 Pac. 1, the deceased was killed when he collided with a train which was crossing a street. The accident occurred at night, and it was foggy at the time. In the cited case, the court quoted from the case of *Keene v. Pacific Northwest Traction Co.,* 153 Wash. 310, 279 Pac. 756, as follows:
>
> " ' "There was, it is true, a fog, at the time, which more or less obscured his [the injured person's] vision, but this, instead of excusing him from exercising care and caution, rather added to his duty in that respect. If he could not see whether

or not he was entering a zone of danger in venturing onto the railway track, it was his duty to take some other means of ascertaining the fact. He could not abandon all caution, take a chance on escaping injury, and, failing to escape, charge his delinquency to another.'"

"See *Dumbolton v. Oregon-Washington R. & N. Co.,* 186 Wash. 433, 58 P.(2d) 806.

"The above cited cases bear out the general rule that, where any condition is present which tends to obscure the view of one approaching a railroad crossing, a greater degree of care, proportionate to the conditions prevailing, is required of such one in determining and observing the danger of approaching trains."

It is held in the State of Washington that a railroad grade crossing is, in and of itself, a proclamation of danger. This rule is promulgated in the case of *Haaga v. Saginaw Logging Company,* 169 Wash. 547, 549, 14 P.(2d) 55:

"We have, in many of our decisions, given judicial expression to what is commonly and currently accepted as a well-known fact, *i.e., that a railroad crossing is a proclamation of danger, and those who propose to enter its zone must govern themselves accordingly."* (Emphasis supplied)

The Railway Company, at a railway grade crossing such as we are concerned with herein, has the right of way over vehicular traffic approaching said crossing. As pointed out in the case of *Morris v. Chicago, M., St. P. & P. R. Co.,* 1 Wn.(2d) 587, 595, 97 P.(2d) 119:

"One who approaches a railway crossing on a public highway is as much under the duty of keeping a lookout as is the railway company; *and with*

> *knowledge that the railway company has the right of way,* and cannot instantly stop its trains to avoid accidents, it becomes his duty to use every means which a reasonably prudent person would use, under the existing circumstances, to avoid a collision." (Emphasis supplied)

It has further been held, and is the law of the State of Washington, that the right of way of the Railway Company is not conditioned upon the giving of signals. The court treated this issue in *Haaga v. Saginaw Logging Company,* 169 Wash. 547, 554, 14 P.(2d) 55:

> "The right of way of the appellants [Railway Company] was an unequivocal one, *and was not conditioned upon their first giving a warning signal.* It was a right that the appellants had under the law, and not one to be acquired by them upon the performance of preliminary conditions. *Sadler v. Northern Pacific R. Co., supra* [118 Wash. 121, 203 Pac. 10]; *Mouso v. Bellingham & Northern R. Co., supra* [106 Wash. 299, 179 Pac. 848]." (Emphasis supplied)

The general rule regarding the duty of the Railway Company in making a train movement such as was made in the case at issue is found in the case of *Porter v. Chicago M. St. P. & P. R. Co.,* 41 Wn.(2d) 836, 843, 252 P.(2d) 306:

> "The courts and textwriters are in substantial accord that when a train of cars enters a street to cross it, vehicle traffic must yield to it the right of way. While occupying the crossing, the train gives actual notice of its presence, and this supersedes all other warning. If upon entering into a street a brakeman takes appropriate measures to warn traffic thereon, the railroad company discharges

its duty of care towards them. These rules, however, cannot be given full application if unusual circumstances or conditions exist making the crossing so peculiarly dangerous that prudent persons cannot use the same with safety unless extraordinary measures are used."

It is noted that the *Porter* case sets out an exception to the rule in a case where unusual circumstances or conditions exist, making a crossing so peculiarly dangerous that prudent persons cannot use the same with safety unless extraordinary measures are used. In this regard, our court has held that knowledge of the hazard, if any, on the part of the plaintiff, puts a higher degree of care upon that party. In the case of *Carroll v. Union Pacific Railroad Co.,* 20 Wn.(2d) 191, 146 P.(2d) 813, the lower court granted a motion for nonsuit, which motion was affirmed on appeal. In the *Carroll* case, the plaintiff had an accident with a train while driving an automobile over a grade crossing where visibility was restricted for the plaintiff because of a hill and growth of grass. However, plaintiff was familiar with this fact. The court states at page 195:

"The close proximity of the bank to the track was a hazard with which appellant was thoroughly familiar from his many years' use of the crossing. The fact that the hazard was increased by grass and weeds growing upon the right of way and upon the bank was also open and obvious. It does not appear that appellant ever sought to lessen this hazard by cutting the grass or weeds, or that he requested respondent to do so. He accepted the dangerous situation as he found it, and crossed the track from south to north frequently, often as many as six times in a day."

And the court states further, at page 197:

> "If he [plaintiff] could not see whether or not he was entering a zone of danger in venturing onto the railway track, it was his duty to take some other means of ascertaining the fact. He could not abandon all caution, take a chance on escaping injury, and, failing to escape, charge his delinquency to another." (Citing *Keene v. Pacific Northwest Traction Co.,* 153 Wash. 310, 279 Pac. 756)

The court has defined an extrahazardous crossing in *Bradshaw v. Seattle,* 43 Wn.(2d) 766, 264 P.(2d) 265, as follows:

> "A crossing is extrahazardous where unusual circumstances or conditions exist which make it so peculiarly dangerous that prudent persons cannot use it with safety unless extraordinary measures are used."

The court has also said that a given crossing may be found to be not extrahazardous as a matter of law. This matter was discussed in the case of *Hopp v. Northern Pacific R. Co.,* 20 Wn.(2d) 439, 147 P.(2d) 950, in which case the court held as follows in determining that the crossing therein was not extrahazardous as a matter of law:

> "The respondent alleged that the crossing was extrahazardous and that the appellants were negligent in failing to keep a watchman or automatic signal alarm bell at the crossing. The deceased was familiar with the crossing and had a clear and unobstructed view of the track, in the direction from which the gas motor coach was approaching, of from 1,000 to 2,800 feet when he was at a distance of one hundred feet from the crossing. In *Mis-*

souri K. & T. R. Co. v. Long, 299 S.W. 854, the court held that a crossing is more than ordinarily dangerous if it is so peculiarly dangerous that prudent persons cannot use the same with safety unless extraordinary means are used to approach such place. The crossing was not an extrahazardous one, as a matter of law, under the facts of this case. Hence, this allegation of negligence must fail."

Appellants argue that a factual question was made out for the jury because the crossing in question was an extrahazardous one. All railroad crossings in the State of Washington are, as a matter of law, dangerous, and the State has promulgated by way of statute and rules the duty of the Railway Company in taking steps to warn approaching motorists of the presence of the train. The courts in this State have found that, at times, because of the existence of certain conditions, a motorist using reasonable care might not be made aware of the existence of the approaching train even though the Railway Company complies with the statute and rules that are sufficient at crossings where said unusual conditions do not exist. When conditions exist which limit or obstruct the view of approaching motorists—for example, atmospheric conditions, physical obstructions such as buildings or brush or the contour of the roadway approaching the crossing—which conditions create an extra hazard to approaching motorists, there may be created a question of fact for the jury as to whether or not the sounding of an audible signal and/or the presence of the train itself is sufficient warning to approaching motorists. Regardless of how dangerous a particular crossing may be, and even if it is found to be extrahazardous, the Railway Company has

a burden of care to safeguard users of the highway by making provision for adequate warning to them when its train movements are going to enter upon the highway. In the instant case, the Railway Company provided an electric red traffic signal, which it is agreed was actuated prior to the entry of the train upon the traveled portion of the street, and was giving a warning up until the time the collision occurred; a flagman preceded the train movement across the street and had stopped traffic in three of the four lanes thereof; and, in addition, the logs on the train were piled to a height of 25 feet above street level, making the train movement clearly visible to anyone looking in that direction. It is appellee's position that the crossing is not extrahazardous, but even though it be determined that a question of fact was made as to the crossing in question being extrahazardous, it should be held as a matter of law, as it was in the case of *Watson v. Northern Pacific Ry. Co.,* 37 Wn.(2d) 374, 223 P.(2d) 1057, that the measures appellee took to warn approaching motorists of the presence of the train were sufficient. The *Watson* case involved a collision between an automobile and a Railway Company engine. Prior to the accident, the engine had been stopped behind a building, which hid it from southbound traffic. It became necessary for the engine to cross the street, so a flagman took his position in the street and a back-up signal was given. As the accident occurred at night, the engine's back-up light was turned on. Two blasts of the horn were given, and the engine bell commenced ringing. The engine backed out into the street at approximately 5 miles per hour. The flagman, meanwhile, was swinging a lantern

which was visible from either direction, although he was facing south. Northbound cars slowed down and came to a stop. The flagman then noticed the car in which plaintiff was riding approaching from the north. He turned to face the oncoming car. *He was then off the highway on its east margin.* The car continued on its course until it struck the leading end of the engine. A trial to a jury resulted in a verdict for plaintiff. However, defendant's motion for judgment n.o.v. was granted on the ground that there was no evidence of negligence on the part of defendant, and that the negligence of the driver of the car was the sole proximate cause of the injury. The plaintiff appealed, and the Supreme Court, in affirming the lower court's granting of the motion for judgment n.o.v., stated as follows (page 375):

> "We are concerned, therefore, solely with the question of whether or not the respondent was guilty of any negligence which was a proximate cause of the injury. This was a dangerous crossing, and that fact imposed upon the respondent a burden of care to safeguard users of the highway against injury by making provision for adequate warning when its engine crossed the highway. The measures it took to do this were sufficient, as a matter of law.
>
> "Assuming that this crossing was extrahazardous, it still did not constitute a trap within the purview of the cases cited by appellant upon that theory.
>
> "[2, 3] When the respondent, by its flagman, took appropriate measures to warn travelers on the highway, it discharged its duty of care toward them. *Tonning v. Northern Pac. R. Co.,* 180 Wash.

374, 39 P.(2d) 1002. We are concerned, in such cases, with the adequacy of the warning given, not with whether a traveler on the highway was aware of the warning. He ought to be aware of an adequate warning. We have repeatedly said that one cannot be heard to say that he did not see that which, without dispute in the evidence, was there to be seen had he looked. *Silverstein v. Adams,* 134 Wash. 430, 235 Pac. 784.

"The trial court was correct in granting a judgment n.o.v."

The case of *Morris v. Chicago, M., St. P. & P. R. Co.,* 1 Wn.(2d) 587, 97 P.(2d) 119, is authority for the right of the trial court to determine that a person is guilty of contributory negligence as a matter of law. Regarding this right, the court, in the *Morris* case, reaffirms the following holding from the case of *McQuillan v. Seattle,* 10 Wash. 464, 38 Pac. 1119, 45 Am. St. 799:

" 'There are two classes of cases in which the question of negligence may be determined by the court as a conclusion of law. . . . The first is where the circumstances of the case are such that the standard of duty is fixed, and the measure of duty defined, by law, and is the same under all circumstances. . . . And the second is where the facts are undisputed and but one reasonable inference can be drawn from them. . . . If different results might be honestly reached by different minds then negligence is not a question of law, but one of fact for the jury.' "

The case of *Hendrickson v. Union Pacific R. Co.,* 17 Wn.(2d) 548, 559, 560, 136 P.(2d) 438, sets forth the conditions in a crossing accident when the court is jus-

tified in making a finding of negligence as a matter of law. The court in this regard stated as follows:

> "Here, again, the impression might have been conveyed that this is a rule of universal application and admits of no exception, and that, when one collides with a moving or standing train on a crossing, he is guilty of negligence as a matter of law. *In the ordinary case, and particularly where the visibility is good, there can be no question about this, and reasonable minds cannot differ.* In those cases where the visibility is poor the measure of care on the part of the user of the highway greatly increases, but we may have situations where reasonable minds might differ as to whether the user of the highway exercised the proper amount of care under the circumstances, and, in such case, the question becomes one for the jury." (Emphasis supplied)

That the driver of the vehicle in which appellants were riding was negligent upon her approach to the crossing cannot be denied. That this negligence was a proximate cause of the collision cannot be denied, and considering the existing circumstances and precautions taken by appellee, appellee submits that the negligence of the driver of the vehicle in which appellants were riding was, in fact, as a matter of law, the sole proximate cause of the collision in question.

Appellants also argue that a factual question was made for the jury on the basis of the trap doctrine under Washington law. Under the facts presented by the evidence herein, appellee cannot visualize what circumstances existed at the time and place to create a trap, other than the conduct of Mrs. Warren, which is not chargeable to appellee. The evidence is undis-

puted that the sun did not interfere with Mrs. Warren's vision, insofar as the presence of the train movement was concerned. The evidence is further undisputed that appellant Cleff, riding in the back seat of the Warren vehicle, saw the train when the Warren vehicle was 100 feet from the crossing, at which time the leading end of the train had entered upon the traveled portion of 11th Street. Mrs. Warren testified that, had she looked in the direction of the train, there was nothing to obstruct her view thereof. Regardless of the other precautions taken by appellee, by these facts alone appellee discharged its duty of warning, insofar as the Warren vehicle was concerned. Appellee submits that, if a train movement is clearly visible to an approaching motorist when the motorist is 100 feet from the crossing (the existence and location of which crossing she was at the time familiar with (R.-2, 27, 28)), at which time the motorist is traveling at a speed of 12 to 15 miles per hour, and said motorist testifies that because of her slow speed there was plenty of time to look for a train, and she was, in fact, looking for a train, as is evidenced by her testimony as follows:

"Q. Well, all right; then as you approached this crossing, your testimony is that you at no time looked for a train?

A. Oh, yes. I had plenty of time to look for the train because I was going slow.

Q. Were you looking for a train?

A. I really was, and I looked more for the flagmen because they are always out there.

Q. But you were also—now testimony is—looking for a train?

A. Well, I was looking for a train and the flagman both. When you are driving, you kind of keep your mind on a little bit of everything.

Q. Well, I don't want to belabor this point too much, but so the jury gets it straight and we all get it straight, as you approached this crossing at some point or other before the impact, you did look for a train?

A. I really looked for the flagman.

THE COURT: No, he wants you to answer the question, Mrs. Warren. We will be here so long if you don't answer. Please answer the question. Did you look for a train?

THE WITNESS: Sure I did.

THE COURT: All right." (R.-2, 40, 41)

then it cannot be determined that the crossing is extrahazardous or in the nature of a trap as to that motorist.

CONCLUSION

In conclusion, appellee calls attention to the trial court's oral decision upon granting appellee's motion to dismiss appellants' complaints, where the court stated as follows:

"I am confident a verdict for plaintiffs on this evidence would not stand. This is a diversity case. We are dealing strictly and solely with the applicable common law of Washington with respect to negligence principles, and it is a basic principle of Washington law of negligence that substantial evidence is required, and a mere scintilla is not sufficient. If the plaintiffs' case rests solely on a scintilla of evidence, either as to negligence, proximate

cause, or damages, any one of the three, there is insufficient evidence for submission to the jury.

"In my opinion, plaintiffs' proof at the very most amounts to only a scintilla of evidence, and that is not sufficient. The evidence shows no negligence on the part of the defendant railway, but even if it be assumed otherwise, there is no evidence whatever, except the wildest speculation, to establish proximate causal relationship of the assumed negligence to the collision in question." (R.-2, 107, 108)

Appellee respectfully submits that the judgments entered herein should be affirmed.

Respectfully submitted,

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Attorneys for Appellee.

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

.....

ROBERT J. ALLERDICE
Attorney

NO. 18217 and 18293
In The
UNITED STATES COURT OF APPEALS
For The Ninth Curcuit

Construction, Production & Maintenance Laborers Union Local 383, AFL-CIO, and United Brotherhood of Carpenters and Joiners of America, Local 1089 AFL-CIO, Petitioners,

vs.

National Labor Relations Board, Respondent

and

Independent Contractors Association, Petitioner

vs.

National Labor Relations Board, Respondent

Brief For

INDEPENDENT CONTRACTORS ASSOCIATION IN CAUSE NO. 18293 IN SUPPORT OF PETITION TO REVIEW AND MODIFY AN ORDER OF THE NATIONAL LABOR RELATIONS BOARD

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INDEX

TABLE OF AUTHORITIES

JURISDICTIONAL STATEMENT

This case is before the Court upon two separate Petitions for review of different portions of the same order of the National Labor Relations Board (hereinafter sometimes called the Board). The Construction, Production & Maintenance Laborers Union, Local 383, AFL-CIO, and United Brotherhood of Carpenters and Joiners of America, Local 1089, AFL-CIO (hereinafter sometimes collectively referred to as the "Unions" or individually as the "Laborers" or "Carpenters") have moved in Cause Number 18217 to review that portion of the Board's Order issued against them on June 26, 1962, pursuant to Sec. 10 (c) of the National Labor Relations Act, as amended (29 U.S.C.A. Sec. 151 et. seq.) (hereinafter sometimes referred to as the Act) which found them in violation of Sections 8 (b) (4) (i) (ii) (A) & (B) of the Act. The balance of the Board's Order is before the Court upon the Petition of the Independent Contractors Association (hereinafter sometimes called the Association) to review and modify a different portion of the same Order of the Board dismissing the part of the Complaint alleging that the Union's recognition picketing had violated Sec. 8 (b) (7) (C) of the Act (29 U.S.C.A. Sec. 158 (b) (7) (C). The Board's action in dismissing the recognition picketing portion of the complaint was also predicated on Sec. 10 (c) of the Act (29 U.S.C.A. Sec. 160 (c) et. seq.) In its Answer to both Petitions the Board has requested that the relief sought be denied. The Association has intervened in the Unions' Petition and both proceedings have been consolidated by Order of this Court. This Court has jurisdiction pursuant to Sec. 10 (f) of the Act (29 U.S.C.A. Sec. 160 (f)).

STATEMENT OF THE CASE

A

PRELIMINARY STATEMENT

1) SCOPE OF THIS BRIEF

In this brief the Association will address itself only to the issues raised by its Petition, requesting review of the Board's Order dismissing that portion of the Complaing before the Board alleging that the Unions' recognition picketing violated Sec. 8 (b) (7) (C) of the Act. The Association supports that portion of the Order of the Board which the Unions seek to review in their Petition. Therefore no discussion of that portion of the Board's Order of the Unions' Petition will be made in this opening brief. The questions raised by the Unions' Petition will be dealt with in a subsequent brief supporting the Board's answer to the Unions' opening brief.

In its decision the Board predicated its action in dismissing that portion of the Complaint, charging the Unions with having picketed for more than a reasonable period of time permitted under the statute, solely on the grounds that there was "no evidence" and "no probative evidence" in the record to establish that in picketing the Colson & Stevens Construction Co. (hereinafter sometimes referred to as the "Employer"), the Unions were engaged in joint action or were acting on behalf of each other. Had the Board found that the Unions were engaged in joint action or acting on behalf of each other, they would have found that the picketing of the employer exceeded the maximum 30-day period permitted by the Act, Sec. 8 (b) (7) (C). Accordingly they then would have found and concluded that both labor organizations by such conduct violated Sec. 8 (b) (7) (C) of the Act. This brief will discuss the insufficiency of the evidence to support the Board's

negative findings and conclusions regarding the joint and concerted nature of the Unions' picketing conduct.

DESIGNATIONS OF THE RECORD IN THIS BRIEF

The Record filed in this Court is contained in three volumes. Volume I is the pleadings and formal papers and these documents are numbered p 1 through 101. Volume II contains the designated portions of the official transcript before the Board and various pages from 1 through 430 are contained therein. Volume III contains the original exhibits introduced in the Board proceeding. Hereafter in referring to the portions of the Record references will be designated by the appropriate Roman Numeral designating the particular volume of the Record followed by the page number as follows: (II 3, 4) (II 400, 402, 410, 4-2) (III G C Ex 44, p 1).

B

THE FACTS OF THIS CASE

1) THE CONTRACT SOUGHT BY THE UNIONS

The Board found and it is undisputed that both Unions by oral demands backed up by picketing sought to have the Employer sign the same identical contract to which both Unions were signatory already. (I 55; III G C Ex 44).

This contract is referred to as the Arizona Master Labor Agreement or the Master Agreement.

The Record discloses that this was the only agreement contemplated or discussed by the parties. (I 55).

II-338); that the Unions did not contemplate changing it for this Employer (II-336-338).

The Witnesseth clause recognizes that the employers will employ large numbers of workmen represented by the various Union signatories and recites the intention of the parties to set "uniform" rates, hours and working conditions for all workmen within the jurisdiction of the signatory unions to wit:

> "WHEREAS, it is the desire of the parties to establish uniform rates of pay hours of employment and working conditions which shall be applicable to all workmen performing any work for the contractors, as such work is hereinafter defined in Article III of this Agreement." (II-G C Ex 44, p 6)

The Witnesseth clause further provides that all of the respective covenants and agreements of the parties are interdependent. The document is designed to be a unified integrated document, each clause and undertaking supporting and providing the consideration for the others. Thus it states:

> "NOW, THEREFORE, in consideration of the premises and of the respective covenants and agreements of the parties hereto, each of which shall be interdependent, IT IS HEREBY AGREED:" (III-G C Ex 44, p 6)

The coverage of the agreement extends to "all" employees of the contractors employed to perform construction work as defined in the contract, see Art. I, Sec. A thereof (III-G C Ex 44, p 6). The work covered by the agreement covers every conceivable type of construction work and is not limited to a description of the jurisdiction of each craft, see Art III (III-G C Ex 44, p 15-16).

The subcontractor clause provides that all work subcontracted by the contractors will also be accomplished pursuant to and in accordance with the terms of the Master Agreement. Thus the Agreement states:

> 'That if the Contractors, parties hereto shall subcontract construction work as defined in hereafter Article III of this Agreement, the terms of said Agreement shall extend to and bind such construction subcontract work, and provisions shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement.''(III G C Ex 44, p 7)

The contract proposes only joint recognition by the Employers of all signatory unions together. Art. II of the Agreement pertaining to recognition provides:

Art. II
Recognition and Dispatching

> 'A. That the CONTRACTORS hereby recognize the UNIONS who are signatory hereto as the sole and exclusive collective bargaining representatives of all employees of the CONTRACTORS signatory hereto over whom the UNIONS have jurisdiction..." (III-G C Ex 44, p 8)

This joint nature of the recognition accorded by the Employer's signature on the agreement is further implemented by his undertaking in Art. II, Sec. (B) (1) of the contract to obtain all of his men from the hiring hall of the Union having jurisdiction over the craft he desires. (III G C Ex 44, p 9).

Because it was contemplated that the Agreement was a joint and concerted action by the Unions they specifically provided for indemnifying themselves for any discriminatory application of the hiring hall procedures by any one of the other Unions. See Art. II, Sec. B (3) (III G C Ex 44, p 10).

The intention to act in concert in the administration of the contract is evident from Art. II, Sec. D (III G C Ex 44, p 10) which provides that a contractor who violates the hiring hall provisions as to one Union releases all the other Unions from obligations under the no strike clause, the grievance and arbitration procedure. Art. II provides:

> "A contractor who violates the provisions of this Article as to referral in the first instance shall not be entitled to protection of the provisions of Article V of this Agreement."

Further evidence of cooperation and coordination between the Unions signatory to the Master Agreement is displayed in the dispatching procedures contained in Art II Sec. E (3) (a). This section provides that preferential treatment be accorded in the hiring halls of every signatory Union to qualified employees who have worked in any one of the four basic crafts for a period of at least 60 days for an employer signatory to the Agreement.

> "Each Dispatching Office shall maintain appropriate registration lists or cards, kept in current form from day to day, and referrals will be made in the following order of preference:
>
> (a) Workmen who are properly qualified, (as hereinafter provided) whose names are properly registered, and who have been formerly employed for a period of at least sixty (60) days by any individual employers signatory

signatory to the Master Labor Agreement in a craft covered by this Agreement in the State of Arizona within the immediately preceding two (2) years. (III G C Ex 44, p 11).

The pattern of joint action and delegation of responsibility and authority between the four crafts is illustrated by the provisions of the grievance machinery contained in Art V and the safety committee set forth in Art X. (III G C Ex 44, p 18-22; 25). The safety and grievance committees are composed of two representatives from the four signatory Unions and two from the contractors. Of necessity, therefore, two of the four Unions must delegate bargaining authority and responsibility to representatives of the other signatory crafts.

Joint action is further evidenced by the uniform and common working rules contained in Art XVI of the Master Agreement. (III G C Ex 44, p 30-38). Although the contract provides different wage scales for each craft and additional separate working rules for each craft, these items are all specifically incorporated into the general agreement and a contractor who signs the agreement binds himself to pay and abide by all of the wage rules and scales, not just those of only one craft. See Art VI of the Agreement (III G C Ex 44, p 23).

THE REQUESTS FOR RECOGNITION AND PICKETING BY THE UNIONS TO OBTAIN THE MASTER AGREEMENT

Both Unions were signatory to the same identical Master Agreement. (III G C Ex 44, p 5-6). They were both members of the Phoenix Building and Construction Trades Council (hereinafter sometimes referred to as the "Council"). (I 59)

The Employer, Colson & Stevens, is a small genera contractor located in Phoenix, Arizona. (I 25-26). The Employer employed employees within the craft jurisdiction of only two unions, namely Carpenters and Laborer (II 177). The rest of the work is sub-contracted to various specialty sub-contractors. (II 177). At the time material hereto the Employer was not signatory to any collection bargaining agreements with any Unions nor were a majority of their employees represented by any Union (II 177).

When the Carpenters learned the Employer was starting a job on a "Yellow Front" store they sent a letter to the Council charging the Employer with engaging in "unfair" competition and requested that the Council place the firm on the "unfair" list. (II 281-283). The Laborers representative, who was an officer of the Council defined the work "unfair" as meaning "unfair competition in the industry insofar as wages, prices and working conditions were concerned." (II 349, 350, 351, 356).

In accordance with their regular procedure, the Council discussed the Carpenters charge and appointed a committee to investigate it. (II 284). The Record does not disclose whether a representative of the Laborers was appointed to that committee. (II 284).

But according to one of the Committee members, the composition of the Committee usually depends upon the type of crafts employed by the Employer involved. (II 384).

The Council Commitee met with the Employer on the "Yellow Front" job on October 14, 1960, and the Carpenters' representative discussed the going along with the Union and signing of the Master Agreement with the Employer. (II 205-359). Years before the Employer had been signatory to the Master Agreement and was familiar with the terms and this was known by the Carpenters' representative. (II 359).

According to Ellison, the Carpenters' representative, the Employer refused to go along with us at this time because of the cost of converting to Union subcontractors. (II 286-359). The Council Committee reported back to the Carpenters (II 286) and thereafter on October 19, 1962, the Carpenters placed a picket on the Employer "Yellow Front" job with a sign reading:

> "Picket against Colson and Stevens, Carpenters Local 1089 wants to organize and represent the Carpenters employed." (I 17).

The Carpenters freely admitted that had the Council Committee obtained the Employer's signature on the Master Agreement on October 14, 1960, they would not have picketed the Employer. (II 328). The Board found and it is not disputed that the object of the picketing was to have the Employer sign the Master Agreement. (I 55). On November 15, 1960, the picketing was discontinued. (II 288). The Carpenters recognized they had picketed for 30 days. (II 368).

On January 10, 1961, a "Survey Committee" from the Council visited the Employers project and arranged a meeting of representatives on January 12, 1961. (II 296).

The Committee reported back to the Council and the Council members formed a Committee to meet with the Employer. (II 298). Representatives of several crafts including Carpenters and Laborers attended the meeting on January 12, 1961. (I 27). At the meeting the question of recognition was again raised. (I 27). The Employer was given copies of the Master Agreement by the Carpenters and there was discussion regarding the possibility of letting the Employer finish the "Church" job with their existing non-union sub-contractors and only requiring the Employer to convert to union sub-contractors on the other jobs remaining and future work. (II 307, 375, 387). The Carpenters asked the Employer to call them before the meeting of the Council the following Tuesday so they could obtain the Council's authorization and approval of the arrangement permitting the Employer to finish the "Church" job with non-union sub-contractors. (II 307, 375, 387).

Shortly thereafter on January 26, 1961, the Laborers commenced picketing the Employer with signs almost identical to those of the Carpenters. (I 17). Like the Carpenters, the Laborers admitted that they would not have picketed the Employer had he signed the Master Agreement. (II 422). The picketing by the Laborers ended on February 20, 1961 (I 27).

SPECIFICATION OF ERRORS

1. The Board erred in dismissing that portion the General Council's Complaint alleging violations of Sec. 8 (b) (7) (C) of the Act (I 59).

2. The Board erred in concluding that the record does not establish joint action by the Unions in picketing the Employer for recognition (I 59).

3. The Board erred in finding that there was "no evidence in this record" that either Union , in seeking recognition, was acting on behalf of the other. (I 58-59). Such finding is totally unsupported by substantial evidence, but on the contrary the substantial evidence in the Record demonstrates each Union was acting as the agent of the other and in each others behalf in seeking recognition and picketing to obtain that objective.

4. The Board erred by failing to find and conclude both Unions, by virtue of their picketing, violated Sec 8(b) (7) (C) of the Act and in failing to issue an appropriate remedial order.

QUESTIONS PRESENTED

1. Whether the provisions of the Master Agreement authorizes and empowers any signatory Union to act as the agent for each of the others in seeking recognition and establishing binding collective bargaining rights and duties with Employers.

2. Whether the Master Agreement sought by both Unions constituted a joint request for recognition.

3. Whether there is substantial evidence in the Record as a whole to support the Board's findings and conclusion that neither Union in requesting joint recognition and in picketing to achieve the identical objectives were engaged in joint action or acting on behalf of each other.

ARGUMENT

A

THE UNIONS' AUTHORITY TO ACT FOR AND ON BEHALF OF EACH OTHER IN SEEKING RECOGNITION IS CONFERRED BY THE TERMS OF THE MASTER AGREEMENT

It is apparent from an examination of the sections of the Master Agreement, in part set out in the Statement of Facts, that the Agreement contemplates only joint and immediate recognition by the employers of all of the Unions signatory thereto. Upon signing the Agreement an employer immediately becomes bound to recognize all not one of the four crafts.

Generally authority to act as an agent in a given manner will be implied whenever the conduct of the principal is such as to show that he actually intended to confer that authority. In re International Longshoremans' Union (CIO) Local 6 and Sunset Line and Twine Company, 79 NLRB No. 207, 23 LRRM 1001, 1005 (1948)

The usual elements of a joint venture are a common interest in the performance of a common purpose, a joint interest in the subject matter, a right to share in the profits and a duty to share in the losses. 48 C. J. S. Sec. 2. It is generally held that one joint venturer may be intrusted with the actual control of the enterprize without changing the status of the venture. 48 C. J. S. Sec.

In the instant case, the Unions clearly had an identical purpose, namely obtaining the Employer's signature on the Master Agreement. This identical and common purpose supplied their common interest in the subject matter of the picketing.

While each may not have had a right to control the picketing activities of the other it is apparent from their

conduct that they were impliedly intrusting each other with the conduct of their respective periods of picketing.

The terms of the Master Agreement clearly spelled out their rights to share in the benefits obtained from recognition.

The Agreement contains no qualifications limiting its application to one craft or the other. Nor is prior approval or authorization from any of the crafts necessary to bring all of the terms and conditions of the Agreement into effect, when signed by an employer. When a duly authorized representative of one of the four basic crafts requests an employer to sign the Master Agreement, by virtue of the terms of that Agreement, that representative is held out by the four basic crafts as being authorized to bind them to the rights and obligations determined by the Agreement. The only conclusion that can be drawn from the interdependent, uniform and common provisions of the Agreement is that it was the clear intention of the parties to bind an employer to recognize and bargain with all of the four basic crafts if that employer recognized or bargained with any one of them. At the very least the Agreement conferred upon the representatives of each of the signatory unions the power and authority to accomplish that task. Certainly there is no evidence in this Record indicating that the Unions denied their authority to request recognition and to bind the other labor organizations by obtaining Employers' signatures to the Master Agreement. The Agreement was and is a single package that designedly could not be separated nor was it the intention of either of the Unions who picketed the Employer herein to change it in any way.

Recognition of the other Unions was not an incidental result flowing from the signing of this Agreement. Immediate recognition of all of the signatory craft was the primary and explicit purpose of the Agreement. Moreover

B

THE UNIONS' CONDUCT IN SEEKING AND PICKETING FOR RECOGNITION DEMONSTRATES THEY WERE ACTING IN CONCERT AND ON BEHALF OF EACH OTHER

It is undisputed that both Unions sought the Employer's signature on the same identical Agreement. It is clear also from the Agreement that it offered only recognition of all four Unions as the exclusive bargaining representative for all of the employees within their respective craft jurisdiction. Apart from this the Record also demonstrate that the Unions coordinated their recognition demands through the council. For example, as a result of a contact by the Council "Survey Committee" the meeting of January 12 was arranged. At the January 12 meeting with the Employer, the Laborers and the Carpenters at the same time jointly requested recognition and the same contract from the Employer.

Had the Laborers and the Carpenters not been acting together in coordinating their activities through the Council it would not have been necessary for either the Laborers or the Carpenters to attempt to obtain approval of the Council to an arrangement that would permit the Employer to finish the "Church" job with his non-union sub-contractors. Had the Carpenters been acting solely for themselves and not in a representative capacity they would have made that decision for themselves and not waited or applied to the Council for approval for the plan.

It made no difference that the Laborers' representative may not have appeared at the October meeting with the Employer for the Carpenters protected their interests by seeking the Master Agreement. In fact, it was unnecessary for any but one member of the four crafts to seek an employer's signature to an Agreement. If the Employer signed for one union the inevitable and intended result wa

that he signed with all of the other signatory unions.

Moreover one of the Council's committee members admitted that the composition of the Council committee usually depends on the type of crafts involved in the Employer's operation. The only reasonable inference from this testimony coupled with the fact that there is no evidence to show that a Laborer's representative in fact was not placed upon the original Council committee, is that it was the intention of the Unions to work together through the Council in seeking and obtaining recognition from this Employer.

C
THERE IS NO SUBSTANTIAL EVIDENCE TO SUPPORT THE BOARD'S FINDINGS THAT NEITHER UNION WAS ACTING ON BEHALF OF THE OTHER

In reviewing orders of the Board, Courts generally respect the inference drawn by the Board from evidentiary facts which are undisputed or within the Board's power to find if "the inference is within the range of reason, although not what the Court would have chosen". NLRB v Marcus Trucking Company, (2d Cir. 1961) 286 F 2d 585, 590. In Universal Camera Corp. v NLRB, 1951) 340 U.S. 474, 71 S. Ct 456, the Supreme Court held that a reviewing court may set aside a Board order when:

> "it cannot conscientiously find the evidence supporting that decision is substantial when viewed in the light that the Record in its entirety furnishes, including the body of evidence opposed to the Board's view".

Petitioner Independent Contractors Association submits that the Board ignored and skirted the material evidence in the Record and consequently its inferences from the facts are not within "range of reason" nor is there substantial evidence to support

its findings when viewing the Record as a whole.

In its decision and order the Board voted that the Laborers did not join in the Carpenters' request to place the Employer on the "unfair" list. This fact is not material. It is obvious both were members of the Council and there was never any evidence adduced to indicate that the Laborers did not share the view of the Carpenters that the Employer was "unfair". Apparently "unfair" really means that the Employer was not abiding by all of the terms of the Master Agreement. It would appear that the Employer was engaging in "unfair" competition insofar as all of the crafts were concerned. At any rate, the investigation of the Employer's "unfair" status was a group undertaking by the Council and an additional complaint from the Laborers would apparently add nothing more to that investigation.

The Board also attached significance to the fact that a representative from the Laborers apparently did not appear with the Carpenters and the other union representatives to request recognition from the Employer and the signing of the Master Agreement on October 14, 1960. (I 58) As previously noted in the preceding portion of this brief this fact is also not material or probative of the issue of joint action when viewed in the light of the fact that the Carpenters by seeking the Employer's recognition of the Master Agreement were thereby openly and automatically seeking recognition and benefits for the Laborers.

Next the Board concluded that there was no probative evidence that the Carpenters were requesting recognition for the Laborers. (I 58) This conclusion completely avoids the undisputed facts in the Record concerning the nature and terms of the Master Agreement, the intentions of the parties reflected therein, the knowledge of the participants as to what was

required by that Agreement and the conduct of the Unions in coordinating their activities through the Council. The only reaonsable inference to be drawn from the Carpenters' request that the Employer sign the Master Agreement is that they were not seeking recognition solely for themselves but for all of the four basic crafts.

Neither Union presented the Employer with a separate contract covering only the craft they represented.

If the Carpenters in fact had no interest or intention to seek recognition from the Employer for both the Laborers and the other four basic crafts than their conduct in insisting on execution of the Master Agreement is tantamount to deceit. Both the Carpenters and Laborers knew that the contract thay they insisted be signed bound the Employer to recognize both of them as well as the other basic crafts. The Petitioner Association does not read the instant Record as establishing that the Unions were attempting to deceive the Employer into thinking that each of them was requesting recognition solely for themselves and not on behalf of any other union. The facts of the matter are that the Employer and all of the Unions assumed the inevitable effect of the execution of the Master Agreement, that the Laborers and Carpenters were acting on behalf of each other and that recognition of one meant recognition of all of the four basic crafts. It was because the Employer recognized this that he requested the presence of the Carpenter's representative at the January 12 meeting so that he could iron out the particular problems he knew he would have with the Union he knew he would be dealing with most frequently.

The "dispute" between the Carpenters and the Employer was that he was not signatory to the Master Agreement and not abiding by its terms. The same condition and "dispute" existed between the Employer and the Laborers.

The Board also ignored the undisputed evidence that at the second meeting of the parties on January 2, 1961, the Carpenters renewed their previous request for recognition and a contract and that the Laborers joined in that request and thereafter picketed in support of the joint request.

The evidence relied upon by the Board to support its conclusion on the joint action issue constitutes no more than a "scintilla" of evidence. The standard of "substantial" evidence requires more than that.

In view of the Record taken as a whole, the findings of the Board and their inferences from the undisputed facts on the joint action issue are not within the "range of reason" and must be reversed.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the Petitioner Independent Contractors Association petition to review and modify the Board's order be granted and the case remanded to the Board for the issuance of an appropriate order.

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(Appendix follows)

Appendix

Table of Exhibits

Exhibit No.	Description	Record Page No.		
		Ident.	Off.	Rec.
1. G C Ex 44	Arizona Master Labor Agreement	II-203	II-204	II-20

IN THE

United States Court of Appeals For the Ninth Circuit

Nos. 18217 and 18293 (Consolidated)

CONSTRUCTION, PRODUCTION AND MAINTENANCE LABORERS UNION, LOCAL NO. 383, AFL-CIO, AND UNITED BROTHERHOOD OF CARPENTERS AND JOINERS OF AMERICA, LOCAL NO. 1089, AFL-CIO, *Petitioners,*

vs.

NATIONAL LABOR RELATIONS BOARD, *Respondent and Cross-Petitioner.*

INDEPENDENT CONTRACTORS ASSOCIATION, *Petitioner,*

vs.

NATIONAL LABOR RELATIONS BOARD, *Respondent.*

On Petition to Set Aside in Part an Order of the National Labor Relations Board and on Cross-Petition to Enforce Same (Case No. 18217): and on Petition to Review Another Part of the Same Order (Case No. 18293)

REPLY BRIEF OF PETITIONING UNIONS

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INDEX

TABLE OF AUTHORITIES CITED

Cases:

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REPLY BRIEF OF PETITIONING UNIONS

The Unions will confine their Reply to the Board's basic arguments that the picketing violated subsections (A) and (B) of Section 8(b)(4) of the Act. For the

sake of convenience, the unions will respond to these arguments in the same order in which the Board presented them.

I

Neither union picketed in violation of Section 8(b)(4)(A).

Without quibbling over what the court meant in the *Sand Door* case *(Local 1976, Carpenters v. NLRB,* 357 U.S. 93) by "legal radiations", the unions agree 1) that the court there held that a union could not, prior to 1959, *enforce* its hot cargo agreement with an employer by conduct which *in fact* violated the secondary boycott subsection of 8(b)(4); and 2) that this decision, to some degree, with its disclosure of the existence of "legal radiations"—"loopholes," if you must—prompted Congress to amend the Act.

However, the description given by the Board in its brief (pp. 16, 17) to these amendments is not quite accurate. Since the Board later in its brief places great emphasis on legislative history, it seems appropriate to note with some preciseness just what these amendments did do. New Section 8(e) was not enacted to outlaw agreements "to engage in secondary boycotts," but to outlaw hot cargo agreements and certain kinds of subcontracting agreements which are "secondary in nature,"—with some exceptions. And, subsection (A) of 8(b)(4) was amended to make it an unfair labor practice not only to "strike or engage in other coercive activity," but also to engage in certain apparently noncoercive activity (for example, "to induce or encourage any individual employed by any person . . . to engage in . . . a refusal" to do certain things in his

employment) with an object of "forcing or requiring any employer . . . to enter into" such agreements.

It should be kept in mind, too, that subsection (B) of 8(b)(4) was amended also to *expressly continue* the lawfulness of a primary strike or picketing.

A. *Section(8) (4) (A) does not prohibit picketing to obtain agreements described in the construction industry proviso in Section (8) (e).*

The gist of the Board's position is that the construction industry proviso allows only the making of *voluntary* agreements and that, conversely, a union may not picket to obtain such an agreement since this would involve an involuntary or coerced agreement.

To arrive at these conclusions, the Board invites the Court to abjure "slavish literalism" in interpreting this proviso and its inter-relation with 8 (b) (4) because, according to the Board, the clear literary purport of the language used "would lead to absurd and incongruous results plainly at variance with the policy of the legislation as a whole." (Bd. Brf. 27)

As was stated in the Unions' Opening Brief, the application of these sections to the facts of this case is *clear*. Resort to the intricate and complex history of this Act should, therefore, not be undertaken. If, however, this Court should determine that it is required to do so, it is respectfully submitted that the legislative history points in the same direction as the plain meaning of the language used in statutes.

It will be recalled that the Landrum-Griffin Act was the product of one of the longest sessions of a Confer-

ence Committee in the history of the Congress. The Conference Committee reconciled the differences between the Senate Bill (S. 1555) and the House Bill (H.R. 8400) which was adopted as a substitute for the Elliott Bill (H. R. 8342) which had been reported by the House Committee on Education and Labor.

The Senate Bill did not proscribe all "hot cargo" clauses. Section 707. (a) of S. 1555 as passed the Senate provided for the addition of a new subsection (e) to Section 8 of the National Labor Relations Act, as amended, which read as follows:

> "(e) It shall be an unfair labor practice for any labor organization and any employer who is a common carrier subject to Part II of the Interstate Commerce Act to enter into any contract or agreement, express or implied, whereby such employer ceases or refrains or agrees to cease or refrain from handling, using, or transporting any of the products of any other employer or to cease doing business with same." Legislative History of the Labor-Management and Disclosure Act of 1959 (hereinafter referred to as Leg. Hist.), Volume I, page 582.

Section 707. (c) of S. 1555 provided that:

> "(c) Any contract between an employer and a labor organization or its agents heretofore or hereafter executed which is, or which calls upon anyone to engage in, an unfair labor practice under Section 8 (e) of the National Labor Relations Act, as amended, shall to such extent be unenforceable and void." Leg. Hist., Volume I, page 583.

The Landrum-Griffin Bill proscribed all "hot cargo" clauses. Section 705. (a) of this Bill amended Section 8 (b) (4) of the National Labor Relations Act, as amended, to make it an unfair labor practice—

> "(ii) to threaten, coerce, or restrain any person engaged in commerce or in an industry affecting commerce, where . . . an object thereof is:
>
> (B) forcing or requiring any person to cease, *or to agree to cease,* using, selling, handling, transporting, or otherwise dealing in the products of any other producer, processor, or manufacturer, or to cease, *or agree to cease,* doing business with any other person . . ." Leg. Hist., Volume I, page 681. (Emphasis added.)

Section 705. (b) (1) added a new Section 8 (e) to the National Labor Relations Act, as amended, which read as follows:

> "(e) It shall be an unfair labor practice for any labor organization and any employer to enter into any contract or agreement, express or implied, whereby such employer ceases or refrains or agrees to cease or refrain from handling, using, selling, transporting or otherwise dealing in any of the products of any other employer, or to cease doing business with any other person, and any collective bargaining contract entered into heretofore or hereafter containing such an agreement shall be to such extent unenforceable and void." Leg. Hist., Volume I, page 683.

Section 705. (b) (2) provided that:

(sic) "(2) Any contract or agreement between

> an employer and a labor organization heretofore or hereafter executed which is, or which calls upon anyone to engage in, an unfair labor practice under Section 8 (e) of the National Labor Relations Act, as amended, shall to such extent be unenforceable and void." Leg. Hist., Volume I, page 683.

It will be noted that Section 8 (b) (4) (A) of the Landrum-Griffin Bill did not contain the provision which is presently part of the Act. The draftsmen made it an unfair labor practice to force a hot cargo agreement by the language of Section 8(b)(4)(B) which is italicized in the quotation of that Section set forth above.

The reformulation of the draft to make the forcing of a prohibited agreement unlawful in Section 8(b)(4)(A) is first found in S. Res. 181 presented to the Senate on August 28, 1959. The Resolution amended Section 8(b)(4)(i)(ii)(A) to read as follows:

> "(A) forcing or requiring any employer or self-employed person to join any labor or employer organization *or to enter into any agreement which is prohibited by Section 8(e)*." Leg. Hist., Volume II, page 1382. (Emphasis added.)

Section 8(e) in S. Res. 181 made the execution of hot cargo clauses unlawful in the same language as that contained in the Landrum-Griffin Bill but added provisos excepting from the scope of such prohibition the building and construction industry and the apparel and clothing industry. The official Analyses accompanying S. Res. 181 stated that:

> "The hot cargo provision(s) outlaw, with certain exceptions, all express or implied agreements be-

> tween an employer and a labor organization by which the employer agrees not to do business with any other person. The proposed secondary boycott provision would forbid any strike or concerted refusal to work on goods where the object is obtaining an *unlawful* hot cargo agreement." Leg. Hist., Volume II, page 1383. (Emphasis added.)

It will thus be seen that the new drafting structure in Section 8 relating to hot cargo agreements and strikes therefor was removed from Section 8(b)(4)(B) of the Act. The intent of the new draft was made crystal clear by the above quotation from the Analyses accompanying the Resolution. Obviously, a strike to obtain a *lawful* hot cargo agreement was not proscribed by the Senate Resolution.

The above analysis of the legislative process is borne out by the following statement contained in House of Representatives Report No. 1147, 86th Congress, First Session—Statement of the Managers on the Part of the House on S. 1555:

> "The House amendment contains provisions amending the secondary boycott provisions of Section 8(b)(4) of the National Labor Relations Act, as amended. The Senate bill does not contain comparable provisions. The conference committee adopted the provisions of the House amendment with the following changes: (1) the phrase 'or agree to cease' was deleted from Section 8(b)(4)(B) because the committee conference concluded that the restrictions imposed by such language were included in the other provisions dealing with prohibitions against entering into 'hot cargo' agreements, and, therefore, their retention in Sec-

> tion 8(b)(4)(B) would constitute a duplication of language; . . .'' Leg. Hist., Volume I, page 942.

There remains the question of the effect of the language of Senator Kennedy's explanation of the Conference Report which was to the following effect:

> ''Since the proviso [for the construction industry] does not relate to Section 8(b)(4), strikes and picketing to *enforce* the contracts excepted by the proviso will continue to be *illegal* under Section 8(b)(4) whenever the *Sand Door* case (357 U.S. 93) is applicable.
>
> It is not intended to change the law with respect to the judicial enforcement of these contracts, or with respect to the legality of a strike to obtain such a contract.'' Leg. Hist., Volume II, page 1433. (Emphasis added.)

It should be noted that the reference to the *Sand Door* case is solely in the context of *enforcement* of the ''hot cargo'' clause. This, of course, is the sole holding in that case as is clearly and fully set forth in the Unions' Opening Brief. If the legislative draftsmen had inferred, as does the Board's brief, that the *Sand Door* case intimated the illegality of a strike to *secure* a hot cargo clause, that intimation would have been carried forward in the careful and informed legislative history which is characteristic of the various legislative moves made with respect to the progress of the legislation.

It should also be noted that the above-quoted statement referred to *judicial* enforceability of hot cargo contracts and the ''legality'' of strikes to secure such

contracts. It is respectfully submitted that there is nothing in the pertinent legislative history of the Act to dispute the assumption that the draftsmen of S. Res. 181 and the Conference Report believed that strikes to secure *lawful* hot cargo agreements were not unlawful. It is also respectfully submitted that the plain meaning of the Statute as supported by the legislative history discussed in this section of the brief should govern rather than the Board's self-serving statements with respect to the effect of the Board decisions prior to 1959 on the "law" as of that time. Suffice it to say, there was no court decision holding that strikes to secure lawful hot cargo agreements, were, *per se,* unlawful.*

So much for the legislative history. Now, for some of the specific arguments made by the Board which require special comment.

It is interesting to observe that the Board, at pages 19-21 of its brief, notes that Congress intended to preserve the law as it was in 1959 in the construction industry because it was necessary to avoid serious damage to the "pattern of collective bargaining in (this) industry." Yet, the very building trades study described by the Board in its brief (pages 19, 20, showed the *necessity* for the subcontractor clause as a means of establishing "a floor under competitive labor costs." But

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*It is interesting to observe that, even in the welter of confusing Board statements on the subject, there is to be found buried in the footnotes of the Board decision in *Teamsters Local 47* (1955), 112 NLRB 923, which is cited in the Board's brief, page 39, the following statement (at page 925): "Whether the union's picketing also violated 8(b)(4)(A) insofar as it sought to regulate future dealings by Bateson and McCann with such subcontractors (not as yet identified) as might refuse to meet the union's wage standards, is a question which we need not and do not decide."

if, as the Board argues, such clauses can be entered into only *voluntarily,* and if they are to be treated as the Board argues elsewhere in its Brief as *non-mandatory* subjects of collective bargaining, then it is obvious that the "well-established employers" who desire to have this floor under competitive labor costs will not have such protection very long. This is true because, while the well-established employers may be willing to *voluntarily* enter such agreements, the employers who are not well established may *not.* Accordingly, those employers who could not be *forced* by picketing to enter such agreements would be able to bid jobs on the basis of labor costs well below those established in the collective bargaining agreements, thereby drawing to themselves all of the work, while the so-called well-established employers would be priced out of the market. To presume that the well-established employers were maintaining *that* kind of a bargaining pattern in 1959 is to presume commercial insanity.

If the bargaining pattern reflected in the study referred to in the Board's Brief means anything, it means that subcontractor clauses were deemed and treated of *necessity* as *mandatory* subjects of collective bargaining. If Congress legislated the construction industry proviso to avoid serious damage to this pattern, then surely it did not reduce these agreements to the status of non-mandatory subjects of collective bargaining by banning picketing to obtain such agreements.

The Board (Bd. Brf. 22-23), in attempting to persuade this Court that a Union cannot picket to obtain a construction industry agreement, seems to mislead in drawing an analogy between the construction pro-

viso in 8(e) and the special treatment afforded the construction industry by the new Section 8(f). In this respect, the Board suggests that 8(f) deals only with "pre-hire collective bargaining agreements" and "union security provisions." In the first place, there is no pertinent connection between 8 (e) and 8 (f), and therefore any analogy is likely to be meaningless. In the second place, Section 8 (f) *also* permits agreements requiring the employer to notify the Union of job opportunities, etc., and agreements which specify minimum training or experience qualifications for employment, or which provide for priorities in employment based upon length of service, etc. These kinds of agreements are specially allowed by Section 8 (f), and surely are not matters of mere *voluntary* agreement, but are instead matters of *mandatory* bargaining. Nothing in the cases or legislative history cited by the Board hold to the contrary. Accordingly, the Board cannot properly say to this Court that Section 8 (f) permits only "voluntary agreements", nor can it say that a Union may never picket to obtain *any* of the kinds of agreements set forth in Section 8 (f). Thus, even the valueless analogy between the proviso in Section 8 (e) and Section 8 (f) becomes no analogy at all.

The Board, at pages 25 and 26 of its Brief, contends that if picketing to *obtain* the 8 (e) proviso were legal, then this would produce results inconsistent with other sections of the Act, particularly those establishing the duty to bargain in good faith concerning *mandatory* subjects of bargaining. In connection with this argument, the Board states that the subcontractor clause does not come within the scope of mandatory bargaining as defined in *NLRB vs. Wooster Div. of Borg-Warner Corp.,* 356 U.S. 342, 349. The fact is that

Borg-Warner did not remotely deal with subcontractor clauses, nor did it lay down any rule by which subcontractor clauses should automatically be declared non-mandatory subjects of collective bargaining.

The subsequently decided cases of *Local 24, Teamsters vs. Oliver,* 358 U.S. 283, *United States v. Drum,* 368 U. S. 370, and that line of cases which is cited in the Union's Opening Brief, are much more in point, and they support the argument that the subcontractor clause in question *is* a mandatory subject of collective bargaining.

By reason of the foregoing, it is respectfully submitted that the construction of Section 8(e) and 8(b)(4), as urged by the *Board,* rather than the plain meaning of these statutes as urged by the Unions, would lead "to absurd and incongruous results plainly at variance with the policy of the legislation as a whole."

B. *The subcontractor clause in the Master Labor Agreement is not an agreement to cease doing business within the intendment of Section 8 (e) of the Act.*

The Board correctly observes that Section 8 (e) must be read to cover only "secondary" activity, the test being whether a particular agreement is fairly within the intendment of Congress to do away with the secondary boycott, *District 9, Machinists v. NLRB,* (CA-DC; 1962) 315 F2d 33, 36. Thus, a contract clause basically intended to preserve the work opportunities in the unit covered by the contract is *primary* in nature, and therefore outside the scope of Section 8 (e), even though an incidental effect of the clause may be to limit the employer's freedom to do business with others. There seems to be no disagreement concerning these basic propositions.

However, *District 9, Machinists, supra,* does not stand for the proposition as suggested by the Board (Bd. Brf. 30) that the subcontractor clause is in every instance secondary in nature, and therefore, like the "hot goods" clause, within the scope of Section 8 (e). The contract involved in *District 9, Machinists, supra,* was quite *different* from the subcontractor clause involved in the instant case. In *District 9, Machinists,* the employer was required, if it contracted out any work, to give preference to shops or subcontractors "approved or having contracts with the Union." The Court ruled that this kind of agreement was not designed, as the Union claimed:

> ". . . to limit the work of employers maintaining labor standards commensurate with those required by the Union. The bare words of . . . (the agreement) do not lend themselves to such an interpretation. They fairly suggest a concurrence between the union and the Association to boycott another employer for reasons not strictly germane to the economic integrity of the principal work unit. Congress has set its face against such concurrence or agreement . . ."

> ". . . the questioned provision is not, as it could have been drafted to be, one which has work preservation as its aim, such as a provision barring all subcontracting; *nor is it in terms a provision to make certain that the subcontractee shall maintain labor standards commensurate with those of the neutral employer.* It is, rather, a provision to make certain that the primary employer is under contract with the Union or for unspecified reasons is approved by the Union . . . Thus, the neutral

employer is not to do business with any other employer which is not acceptable to the Union." (Emphasis added.)

In a very recent case, *Bakery Wagon Drivers & Salesmen, Local 484,* vs. NLRB (CA DC; May 23, 1963), ... F2d ....., 47 LC, Para. 18,278, the same Court noted that its previous decision in *District No. 9, Machinists, supra,* had held "that contracts which limit subcontracting to employers having a contract with the same Union are illegal." In *Bakery Wagon Drivers,* the Court was faced with the Union's contention that the agreement involved "merely required maintenance of equivalent working conditions." The conduct involved was a strike to *enforce* a no-subcontracting agreement against Employer A in order to solve a dispute with Employer B. The Court condemned the use of the no-subcontract clause *when so used* because it would destroy the basic premises "upon which subcontracting clauses, which prima facie violate subsection (B), are permitted, i.e., *that the Union is seeking to protect some legitimate economic interest of the employees* of . . . (employer A)". (Emphasis added.)

The distinctions between primary and secondary subcontract clauses noted in *District 9, Machinists* and in *Bakery Wagon Drivers,* supra, are entirely consistent with *Local 24, Teamsters vs. Oliver,* 358 U. S. 283, and the accompanying line of cases cited by the Unions in their Opening Brief, to the effect that unions and employers may legally agree upon matters threatening the maintenance of area wage standards and conditions or the basic wage structure and conditions established by the collective bargaining agreement.

The subcontractor clause in the instant case falls within the type of agreement approved by *Oliver* and the other cases cited in the Opening Brief. The fact that it establishes the minimum wage to be paid to subcontractor employees does not detract from its legitimacy. The distinctions to be observed are not—as the Board urges—whether the agreement in question determines wages and conditions to be observed outside the bargaining unit, but whether or not it is aimed really "at the Union's difference with another employer", *Local 636, Plumbers v. NLRB* (CA DC) 278 F2d 858, rather than at the protection of the jobs and standards of the employees in the bargaining unit. For example, a contract clause which establishes the minimum wage to be paid by a subcontractor to his employees may or may not come within the prohibitions of Section 8 (e), depending upon the purpose or object. And this is a question of fact in every instance.

That the subcontractor clause involved in the instant case is *primary* in nature and therefore not within the scope of Section 8 (e) at all, is fully developed in the Union's Opening Brief and will not be repeated here.

To the Board's comment (p. 36) to the effect that the clause is broader than the payment of wages and to the suggestion that it requires subcontractors to *recognize* the petitioning Unions, this may be answered by the observation that wages alone do not constitute the sole subject matter of collective bargaining, that there are many other factors which go into the establishment of employment standards. Further, and for the record, it should be observed that, although General Counsel alleged in the Complaint that an object of each of the Union's picketing was to "force or require Colson's subcontractors, including Riggs, Swartz,

and Haun, to recognize and bargain with Respondent Local 383, or Respondent Local 1089, or other labor organizations, as the representatives of the employees of such subcontractors," nonetheless, neither the Trial Examiner (R. 25-28) nor the Board in its Decision (R. 54-60) made such a finding. By implication, therefore, it must be deemed that this issue was determined *contrary* to the Board's allegation and to its suggestion.

By reason of the foreging, it is respectfully submitted that the Board's argument that the subcontractor clause in question is an agreement to cease doing business within the intendment of Section (e), is without merit.

II

The Union's picketing for the Master Agreement did not violate Section 8(b)(4)(B) of the amended Act.

As was stated fully in the Union's Opening Brief, (pp. 24-30) the law prior to the 1959 amendments did not, *per se,* forbid picketing to *obtain* a hot cargo agreement or a subcontract clause. Also, as stated in the Opening Brief, as well as earlier herein, Congress made it plain when it amended the Act that it understood such picketing to be legal. Congress expressly undertook to outlaw such picketing generally, and then just as expressly, exempted the construction industry where the subcontract clause related to work to be done at the jobsite. See 8(b)(4)(A) and 8(e). *LeBus v. Local 60, United Assn. of Journeymen, etc., 193 F. Supp. 392; Cuneo v. Carpenters,* etc., 207 F. Supp. 932.

Since the Opening Brief, another court has been heard from. In *Cuneo v. International Union of Oper-*

ating Engineers, Local 825, et. al., ... F. Supp. ..... (April 16, 1963), 47 LC Para. 18,229, the Union was charged, as here, with violations of 8(b)(4)(A) and (B) in connection with work stoppages arising out of *negotiations for an agreement containing a construction-industry type subcontractor clause.* After holding this conduct *not* in violation of Subsection (A) on the basis of the decision in *Cuneo v. Carpenters,* supra, the court then said:

> "Section 8(b)(4)(B) of the Act was not involved in Judge WORTENDYKE'S decision. (Cuneo v. Carpenters, Supra.) The Board claims that respondents' strike action against members of the Association *to force them to enter into a collective bargaining agreement containing a subcontractor clause,* which would require them to cease doing business with subcontractors who are not covered by such agreement, is *per se* a violation of section 8(b)(4)(B) of the Act. *The Court does not agree with this contention.* Since the proviso in section 8(e) of the Act protects under sections 8(b)(4)(A), work stoppages to obtain a subcontractor clause, such action by respondents against members of the Association cannot be unlawful under section 8(b)(4)(B) of the Act. *Otherwise, the proviso in section 8(e) would be rendered meaningless."* (Empha. added)

At the trial level of this case, the Board based its contentions of an 8(b)(4) violation on the very same *per se* argument. General Counsel elicited testimony calculated to prove that each union picketed to force Colson to sign the Master Agreement. Except for establishing the existence of the subcontractor clause in that Agreement, he made no attempt to show that the

Union had *as a matter of fact* any dispute, active or otherwise, with the named subcontractors, nor that either of the unions were picketing *with a subjective intent* to force the named subcontractors off the job.*

When the Unions sought to show the *absence* of any dispute whatsoever with the named subcontractors, General Counsel objected as to the *relevancy,* (Tr. 352) explaining that he was relying *solely* on the *per se* theory that picketing to force the execution of the agreement was a violation of subsections (A) and (B) of 8(b)(4).

This *per se* approach also represents the position taken by the Board in its subsequent decisions in other cases, in which it cites this Colson and Stevens case as the *leading authority* in this area of the law. *Los Angeles Building & Construction Trades Council,* 140 NLRB No. 124, 52 LRRM 1215.

However, the Board in its Brief (pp. 37-47) seems to be sidling off from its *per se* theory. This is reflected by the Board's citation of cases dealing with the common garden variety of secondary boycott, that is, where a neutral employer is intentionally pressured in order to resolve a dispute, active or otherwise, with some "blacklisted" employer. It is also reflected in the Board's unwarranted references to "persons in the blacklisted group," to "delisting," "blacklist," etc. There, of course, is no evidence whatsoever support-

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*It will be recalled that when the Carpenters Union spoke to Colson in October and when it began picketing on Oct. 19th in order to force recognition, and arguendo, the execution of the Agreement, *so far as the Union knew*—and this is undisputed (Tr. 359)—the Colson job was *all-union* except Colson. The court is reminded further that the subcontractor clause, in any event, was *not* applicable to the subcontractors named in the complaint for the several reasons stated in the Union's Opening Brief at p. 14 et seq.

ing such characterizations. And, for the *first time,* the Board now says (Bd. Brf. 46) that its Decision "rejected" the Trial Examiner's finding that "enforcement" of the subcontractor clause was left to the future. (R. 28) In this connection, however, the Board does *not* argue nor even suggest that the picketing was accompanied with an intent by either union *to continue doing so* until the named subcontractors either agreed to abide by the Agreement or until Colson forced them off the job. In fact, the Board's argument in the context of rejecting the Trial Examiner's reasoning that *enforcement* of the subcontractor clause was left to the future, distinguishes between the "immediate objective" of signing and the "ultimate objective vis-a-vis the subcontractors," thereby itself acknowledging that *enforcement* was *in fact* left to the *future* as compared to the immediate object of getting the agreement signed.

Thus, logically, the Board must *come back* to the *per se* argument that picketing to obtain a construction-industry type of subcontractor clause, *without more,* is a violation of 8(b)(4)(B). However the cases cited by the Board in support of this proposition are all clearly disinguishable on their facts. And as has been earlier shown herein and in the opening brief, the Congress expressly and plainly declared that picketing to *obtain* construction-type subcontractor clauses, *even assuming they are secondary in nature,* is *lawful.*

Lastly, in connection with the suspicion that the Board may now also be arguing that each of the unions picketed with an illegal subjective intent directed at the termination of any contracts between Colson and any of the named subcontractors, in the manner involved in *NLRB v. Local 47, Int'l Brotherhood of Teamsters,* 234

F. 2d 296 (C.A. 5), it is respectfully submitted 1) that it is procedurally improper to so argue after having led the Unions and the Trial Examiner to believe that it was relying solely on the *per se* theory, and 2) that as a matter of fact there is not sufficient evidence supporting a finding of subjective intent, or object, on the part of either union of a kind prohibited by Subsection (B) of 8(b)(4). The lack of *specific* evidence of *unlawful motivation* is acknowledged by the reliance by the Board upon *NLRB v. Erie Resistor Corp.*, ... U.S. ....., 53 LRRM 2121, 2124. That case, dealing with a limited *evidentiary* rule in discrimination cases, is of no aid to the Board's argument in the instant case since the conditions precedent to the use of the *Erie* rule are not present in the instant case.

It is respectfully submitted that neither union's picketing for the Master Labor Agreement was in violation of Section 8(b)(4)(B) of the amended Act.

CONCLUSION

The Board's Decision and Order insofar as it declares each of the petitioning unions to be guilty of violating the two subsections of 8(b)(4) should be reversed and ordered dismissed.

Dated this 14th day of June, 1963, at Phoenix, Arizona.

Respectfully submitted,

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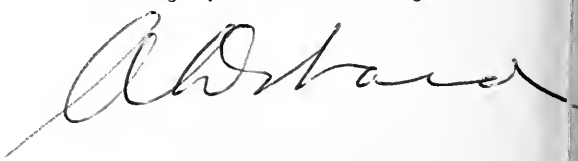

CERTIFICATE

The undersigned certifies that he has examined the provisions of Rules 18 and 19 of the United States Court of Appeals, Ninth Circuit. In his opinion, the tendered brief conforms to all requirements.

MINNE & SORENSON
ANDERSON D. WARD

By .....

In the United States Court of Appeals for the Ninth Circuit

No. 18,217

CONSTRUCTION, PRODUCTION & MAINTENANCE LABORERS UNION LOCAL 383, AFL-CIO; AND UNITED BROTHERHOOD OF CARPENTERS AND JOINERS OF AMERICA, LOCAL 1089, AFL-CIO, PETITIONERS

v.

NATIONAL LABOR RELATIONS BOARD, RESPONDENT

and

INDEPENDENT CONTRACTORS ASSOCIATION, INTERVENOR

No. 18,293

INDEPENDENT CONTRACTORS ASSOCIATION, PETITIONER

v.

NATIONAL LABOR RELATIONS BOARD, RESPONDENT

On Petitions To Review and On Cross-Petition for Enforcement of An Order of the National Labor Relations Board

BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

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INDEX

AUTHORITIES CITED

Cases: Page

Statute—Continued Page

Miscellaneous:

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BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

JURISDICTION

This consolidated case is before the Court upon petition of Construction, Production & Maintenance Laborers Union Local No. 383, AFL-CIO, and United Brotherhood of Carpenters Local No. 1089, AFL-CIO (hereafter referred to individually as Local 383 and Local 1089, and collectively as "the Unions") to review an order of the National Labor Relations Board issued against them on July 26, 1962, following proceedings under Section 10 of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C. Sec. 151, *et seq.*), and upon the separate petition of Independent Contractors Association (hereafter, "Association") to review another portion of the Board's order dismissing certain allegations in the complaint. The Association has also intervened in connection with the Unions' petition. The Board's decision and order (R. 54-67, 25-32)[1] are reported at 137 NLRB No. 149. In its answers, the Board has cross-petitioned for enforcement of its order against the Unions and has requested denial of the Association's petition. This Court has jurisdiction of the proceedings under Section 10(e) and (f) of the Act, the unfair labor practices having oc-

[1] References to the pleadings, the decision and order of the Board, and other papers, reproduced as "Volume I, Pleadings," are designated "R." References to portions of the stenographic transcript reproduced pursuant to Court Rules 10 and 17 are designated "Tr." Wherever a semicolon appears, references preceding the semicolon are to the Board's findings; those following are to the supporting evidence.

curred at Phoenix and Scottsdale, Arizona, within this judicial circuit.

COUNTERSTATEMENT OF THE CASE

I. The Board's Findings of Fact

Briefly, the Board found that the Unions violated Section 8(b)(4)(i) and (ii)(A) and (B) of the Act by picketing Colson and Stevens Construction Company, Inc., herein called Colson, to force Colson's acceptance of contract terms, prohibited by Section 8(e) of the Act, which would have required Colson to cease doing business with its nonunion subcontractors unless the latter also complied with the contract's provisions. The evidence upon which the Board's findings rest may be summarized as follows:

Colson is a general contractor in the building and construction industry in Phoenix, Arizona, where in October, 1960, it was beginning work on a construction project known as the "Yellow Front store" (R. 25-26; Tr. 172, 188, 245-246). At that time, its employees were not represented by any union, nor had Colson been party to any collective bargaining agreement during its two-year existence (Tr. 176-177, 264). Early in October, Local 1089 asked the Phoenix Building and Construction Trades Council to put Colson on its "unfair" list, and in response to this request the Council appointed a committee to investigate the matter (R. 26; Tr. 280-285).

On October 14, a group from the Council including Ralph Ellison, assistant business representative of Local 1089, approached Colson and Stevens at the

Yellow Front construction site (R. 26; Tr. 357). Ellison asked Company President Walter Colson to recognize Local 1089 as representative of Colson's carpenter employees by signing with the Union, reminding Walter Colson that "he had been signatory to the agreement before" (R. 26; Tr. 190, 359).[2] Walter Colson understood that recognition of Local 1089 would mean adoption of the "Arizona Master Labor Agreement," [3] Article I-C of which provided (R. 26-27; Tr. 190, 192-193, G.C. Exh. 44):

> That if the Contractors, parties hereto shall subcontract construction work as defined hereafter in Article III of this Agreement, the terms of said Agreement shall extend to and bind such construction subcontract work, and provisions shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement. A subcontractor is defined as any person, firm or corporation who agrees under contract with the general contractor or his subcontractor to perform on the job site any part or portion of the construction work covered by the prime contract, including the operation of

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[2] Walter Colson, as president of other construction companies, had in past years been signatory to the Carpenters' agreement (Tr. 192, 367).

[3] A "master" collective agreement to which Local 1089, Local 383, and a number of other labor organizations are parties, together with a number of Arizona general contractors and contractors' associations, it consists of twenty articles of general applicability, supplemented by appendices fixing wages and working rules for particular crafts (R. 26; G.C. Exh. 44).

> equipment, performance of labor and the furnishing and installation of materials. . . .

Colson noted that he had some non-union subcontractors on the Yellow Front project and, because signing up with Local 1089 would entail dropping such subcontractors, told Ellison that the Company could not then afford to recognize his union; "it would work a hardship on the company . . . the cancelling of the [sub]contracts . . . that were already tied up" (R. 26-27; Tr. 190-191, 248-249).[4]

On October 19, on the basis of Ellison's report of his meeting with Colson the previous week, Local 1089 established a picket at the Yellow Front project site, his sign proclaiming a purpose to "organize and represent" Colson's carpenters (R. 27; Tr. 285-288, 193, 250). As a consequence of the picketing, which continued until November 17, delivery of supplies to the project was impeded (R. 27; Tr. 250-251, 253-254, 255-256, 257-258, 195-198, 127-128, 144-146, 199, 234).

Union representatives again met with Colson and Stevens on January 12, 1961. This time the group included a representative of Local 383, and Ellison of Local 1089 was present as before, now accompanied by his union superior, Clyde English (R. 27; Tr. 258-260, 300, 205, 285-286). Again the question of recognition and "the agreement" was raised; "the whole meat of the conversation was to join the union

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[4] The Schwartz Plumbing Company and Earl H. Haun, a masonry contractor, both non-union, participated in the Yellow Front construction project under subcontracts from Colson (Tr. 141-142, 121-122, 127).

or become signatory to the Arizona Master Labor Agreement," copies of which were given to both Colson and Stevens (R. 27; Tr. 201-204, 260, 264-265, 301-302, 304). During discussion of the necessity of Colson obtaining subcontractors who would comply with the Master Agreement, Colson protested that the firm had a church construction project then under way and could not very well "convert that job to all union subcontractors," whereupon a member of the group suggested the possibility of Colson being allowed to "slide through" on the church job provided it convert to all union subcontractors for the construction of two schools on which the Company had been awarded the prime contract (R. 27; Tr. 202, 302, 305A, 261, 204). Colson said this would work a hardship on the Company, but that it would compare prices of union and nonunion subcontractors in its files, and if the differential was small enough, the Company would "consider their proposition—becoming signatory to the Arizona Master Labor Agreement" (R. 27; Tr. 202-203, 204, 305B-306, 341-342, 262). The unions, in turn, stated that they would take up with the other members of the Building and Construction Trades Council at its meeting five days hence the matter of permitting Colson to complete its church project with the subcontractors then on the job (Tr. 206, 306-307, 341-342, 374-375, 262).

Colson and Stevens had no further personal contact with the Unions (Tr. 269, 208). However, on January 25, after the Company and its subcontractors had begun construction of the Tonto and Kiva

schools, Local 383 posted a picket at the school sites, the picket sign reading, "Picket against Colson and Stevens. Laborers Local 383 wants to organize and bargain for laborers employed by Colson and Stevens." (R. 27; Tr. 400-401, 262-264). Patrolling was maintained until February 20 when Local 383 "pulled the picket off" (R. 27; Tr. 401). During the period of picketing, suppliers of both Colson and its subcontractors failed to made deliveries because their employees would not cross the picket line (R. 27; Tr. 266, 129-130).[5]

II. The Board's Conclusions and Order

The Board, all five members participating, unanimously concluded from the foregoing facts that Local 1089 and Local 383 violated Section 8(b)(4)(i)(ii)(A) and (B) of the Act by picketing for the Arizona Master Labor Agreement with its Article I-C, a contract clause proscribed by Section 8(e) of the Act, and thereby to force Colson to cease doing business with its nonunion subcontractors if they too did not abide by the contract's terms (R. 54-57). The Board further concluded, two members dissenting, that since neither union's picketing was conducted for more than a reasonable time not to exceed 30

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[5] While Colson's subcontractors on the schools included Earl Haun, who had also been masonry subcontractor on the Yellow Front project, and Riggs Plumbing and Heating Company, the Tonto and Kiva projects were not totally nonunion (Tr. 208-209, 269). In each case, the termite-proofing subcontractor, who was unionized, performed its work during the period of picketing but after 5:00 p.m. when the picket had left for the day (Tr. 270, 272-274).

days, and the record did not establish joint action so as to make each union responsible for the other's picketing, the Unions had not violated Section 8(b)(7)(C) of the Act (R. 57-59).

The Board's order requires the Unions to cease and desist from the unfair labor practices found and, affirmatively, to post appropriate notices (R. 60-62, 66-67).

ARGUMENT

I. The Board Properly Found That the Unions' Picketing of Colson Violated Section 8(b)(4)(i)(ii)(A) and (B) of the Act

A. *Introduction—the statutory provisions and the issues*

Section 8(b)(4)(i) and (ii)(A) and (B) of the amended Act, like their predecessor, Section 8(b)(4)(A) of the Taft-Hartley Act, are basically "secondary boycott" provisions, aimed at prohibiting a union from enmeshing a neutral employer in the union's differences with other, "primary" employers. As did their predecessor, the amended provisions proscribe particular types of conduct by unions for particular objectives. The conduct condemned is that described by subsections (i) and (ii) of Section 8(b)(4), which prohibit a labor organization from striking or inducing a strike or refusal to perform services, or threatening, restraining or coercing any person, for an objective contained in paragraph (A) or (B) of 8(b)(4). No issue is presented in this case with respect to the means used by the Unions, for each concededly picketed Colson, and picketing is

manifestly within the scope of subsections (i) and (ii).

Subsection (B) of 8(b)(4) contains essentially the same unlawful object that was contained in Section 8(b)(4)(A) prior to the 1959 amendments. In effect, that object is to force one person to cease doing business with another, and, with respect to the amended (B) as well as the old (A), by consistent construction the person subject to the union's proscribed pressure must be a neutral. Subsection (A) of the amended Act repeats one of the unlawful objects contained in the old Section 8(b)(4)(A)[6] and adds a wholly new unlawful object, that of forcing or requiring any person "to enter into any agreement which is prohibited by Section 8(e)." Section 8(e), in turn, provides:

> It shall be an unfair labor practice for any labor organization and any employer to enter into any contract or agreement, express or implied, whereby such employer ceases or refrains or agrees to cease or refrain from handling, using, selling, transporting, or otherwise dealing in any of the products of any other employer, or to cease doing business with any other person, and any contract or agreement entered into heretofore or hereafter containing such an agreement shall be to such extent unenforcible and void:

Section 8(e) then sets forth two provisos. The first, which relates to the construction industry, states:

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[6] This repeated object, which is not relevant here, is "forcing or requiring any employer or self-employed person to join any labor or employer organization."

> Provided, That nothing in this subsection (e) shall apply to an agreement between a labor organization and an employer in the construction industry relating to the contracting or subcontracting of work to be done at the site of the construction, alteration, painting, or repair of a building, structure, or other work:

The second, which relates to the garment industry and is not directly involved here but is of significance, as we show below, in interpreting the scope of the first proviso, states:

> Provided further, That for the purposes of this subsection (e) and section 8(b)(4)(B) the terms "any employer," "any person engaged in commerce or an industry affecting commerce," and "any person" when used in relation to the terms "any other producer, processor, or manufacturer," "any other employer" or "any other person" shall not include persons in the relation of a jobber, manufacturer, contractor, or subcontractor working on the goods or premises of the jobber or manufacturer or performing parts of an integrated process of production in the apparel and clothing industry.

The Board concluded that the Unions violated Section 8(b)(4)(i)(ii)(A) and (B) of the Act by picketing Colson, a general contractor, to force or require Colson to enter into an agreement that it would do business only with subcontractors who would abide by the contract's provisions, and, therefore, as a consequence, to compel Colson to cease doing business with its nonunion subcontractors Schwartz, Riggs and Haun, if they did not so comply. The sub-

contracting clause sought by the Unions provided as follows:

> That if the Contractors, parties hereto shall subcontract construction work as defined hereafter in Article III of this Agreement, the terms of said Agreement shall extend to and bind such construction subcontract work, and provisions shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement. A subcontractor is defined as any person, firm or corporation who agrees under contract with the general contractor or his subcontractor to perform on the job site any part or portion of the construction work covered by the prime contract, including the operation of equipment, performance of labor and the furnishing and installation of materials. . . .

The Unions contend that the Board's conclusions are insufficiently supported in fact and erroneous in law. Thus, they argue that there is not substantial evidence that "an object" of their picketing was to force Colson's acceptance of the Arizona Master Labor Agreement, and that, in any event, picketing for such an object is "primary" and therefore not within the reach of Section 8(b)(4)(A) or (B)—the "secondary boycott" provisions of the amended Act. In the latter connection, they assert that subcontracting clauses like Article I-C of the Master Agreement deal with mandatory subjects of bargaining for which strike pressure may be employed. The Unions further contend that Section 8(b)(4)(A) and (B) cannot apply to their conduct because a proviso to Section 8(e) legalizes in the construction industry agree-

ments to cease doing business that would otherwise be unlawful under Section 8(e). Finally, they urge that the subcontracting clause in question would not require Colson to cease doing business with other persons within the meaning of Section 8(b)(4)(B).

We show below that the Board's conclusions are in all respects proper in law and supported by substantial evidence on the whole record. We show further that the defenses advanced by the Unions are without merit.

B. *Substantial evidence supports the Board's finding that an object of each union's picketing was to force Colson to adopt the Arizona Master Labor Agreement*

The evidence summarized above fully establishes that each Union "by its picketing and oral demands, sought to have Colson sign the Master Agreement" with its provision restricting the persons with whom the employer might do business (R. 55). Thus, when the group of union agents first accosted Colson at the Yellow Front construction site in October and Local 1089's representative, Ellison, asked for recognition, discussion focused on Colson "signing their agreement" (Tr. 190). Clearly, recognition meant signing a contract, and this in turn meant the Master Agreement. Thus, Ellison's admitted purpose in calling on Colson was to negotiate a contract, and his union superior admitted at the hearing that in the view and practice of Local 1089, "to negotiate a contract" is "getting [the employer] to sign the Arizona Master Labor Agreement" (Tr. 336-338, 368). And while "perhaps," as the Trial Examiner noted, the

Master Agreement "was not formally proposed by Ellison on October 14," the record reveals and the Examiner further noted that Colson, who was familiar with the Union's bargaining practices, "obviously knew" that this was Ellison's objective (R. 28; Tr. 190, 192-193).[7]

When Colson refused to sign, explaining that the company could not afford to drop its nonunion subcontractors, the conversation came to an end and, shortly thereafter, pickets appeared at the Yellow Front site, their signs demanding recognition and bargaining rights (*supra*, p. 5). Local 1089 admittedly ordered the picketing in response to Colson's October 14 refusal to grant the Union's demands (Tr. 285-287). Accordingly, the Board could reasonably conclude that the Union's objective in picketing on and after October 19 was acceptance of the Master Agreement which, less than a week earlier, Colson had rejected.

Likewise, after Colson again declined to become party to the Master Agreement at the January 12 meeting with representatives of Local 1089, Local 383, and other unions, Local 383 began picketing the Tonto and Kiva school construction projects. The testimony of both company and union participants in the January 12 meeting shows that it was addressed

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[7] At the outset of their conversation, Ellison reminded Colson that "he had been signatory to the agreement before" (Tr. 359). As a witness, Ellison explained that Colson, on behalf of construction companies which he then headed, had in two prior years "signed two other contracts for me personally" (Tr. 367).

almost exclusively to the question of Colson signing the Master Agreement, copies of which were presented to each Colson partner, and to the consequences for the Company's subcontracting arrangements should Colson sign (R. 27; Tr. 201-204, 260-262, 264-265, 301-302, 304-305, 362-363, 364). Union witnesses admitted at the hearing that, as Colson and Stevens testified, the partners had resisted signing because "it would work a hardship on them if they had to change [sub]contractors in the middle of [a] church" that they were then building, admitted further that a union agent suggested the possibility of making the forthcoming school projects the "breaking-off point" when Colson would cease using nonunion subcontractors, that the Company then agreed (although subcontracts had already been let for the schools) to investigate the cost of substituting all-union subcontractors and to consider signing the Master Agreement if such a substitution were feasible, and finally that the unions agreed to propose at their Building Trades Council meeting the next week that the Company be permitted to complete its church construction job with its existing nonunion subcontractors (Tr. 302, 304-307, 341-342, 364, 374-375, 386-388). As the petitioning Unions note in their brief, p. 8, the record contains conflicting testimony as to what was said during the meeting about subsequent communication between the unions and Colson;[8] but whatever may have been said as the meet-

[8] According to Colson and Stevens, the unions were to inform them of the result of the Building Trades meeting and also whether Haun, who had earlier been awarded a sub-

ing concluded, it is uncontested that, as matters turned out, there was no further contact of any sort between the Company and the unions until Local 383's picket appeared at the Tonto school construction site two weeks later, on January 25, his placard demanding bargaining rights for Colson's laborers. Considering Local 383's participation in the January 12 meeting, the acknowledgment by its business agent that it would not have picketed had Colson signed the Master Agreement at that time or had it agreed to do so prior to the Building Trades meeting five days thereafter, and the fact that admittedly Local 383 did not otherwise contact Colson concerning a contract either before or after posting its picket (Tr. 400, 421-423), the Board was fully warranted in concluding that the objective of Local 383's picketing was to force Colson's acceptance of the Master Agreement.

C. *The Unions' picketing for a secondary subcontracting clause violated Section 8(b)(4)(A) of the amended Act*

During the decade following enactment of the original secondary boycott provisions of the Act it became apparent that unions could still successfully

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contract on the school projects, would also go union; and at that time they were to tell the unions "where we stood with our subcontractors" (Tr. 204-205, 206-207, 262). However, according to Clyde English, business representative of Local 1089 and the chief union spokesman at the meeting, Colson was to telephone him prior to the Building Trades meeting with the Company's decision on signing the Master Agreement and converting to union subcontractors (Tr. 307, 341-342, 280, 301).

subject "unoffending employers and others [to] pressures in controversies not their own" (*N.L.R.B.* v. *Denver Bldg. & Construction Trades Council*, 341 U.S. 675, 692) by writing into collective bargaining agreements provisions committing an employer to cease doing business with others to whom the contracting union objected. For in *Local 1976, Carpenters* v. *N.L.R.B.*, 357 U.S. 93 (the *Sand Door* case), while holding that such a contract could not be enforced by strikes or inducements of employees concertedly to withhold services, the Supreme Court made clear that "an employer may *voluntarily* sanction and support a boycott and hence his *agreement* to do so is not unlawful" (*N.L.R.B.* v. *Amalgamated Lithographers*, 309 F.2d 31, 39 n. 12 (C.A. 9), cert. denied, 372 U.S. 943 (emphasis added)). The agreement itself was lawful, with "legal radiations" (*Sand Door* at 108); that is, it was enforceable by any means other than those specifically prohibited by Section 8(b)(4). Moreover, were an employer unwilling thus to consent to a boycott, the union could back up its contract demand with economic or other pressure "so long as it refrain[ed] from the [sole] prohibited means of coercion through inducement of employees" (*id.* at 99).

As this Court has pointed out, it was the loopholes disclosed by the *Sand Door* decision that motivated Congress, in 1959, to enact the new Section 8(e) outlawing agreements to engage in secondary boycotts and "[to add] language to section 8(b)(4)(A) making it an unfair labor practice for a union to strike

or engage in other coercive activity *for the purpose of forcing an employer to enter into an agreement of the kind described in section 8(e)" (N.L.R.B.* v. *Amalgamated Lithographers*, 309 F.2d 31, 39 n. 12 (C.A. 9), cert. denied, 372 U.S. 943 (emphasis added)).

As we discuss more fully below, pp. 27-36, Article I-C of the Arizona Master Labor Agreement for which the Unions picketed Colson, since it would have barred Colson from continuing to subcontract to any subcontractor not willing himself to be bound by the Master Agreement, is indisputably "an agreement of the kind described in section 8(e)" (*Amalgamated Lithographers, supra*). Accordingly, the Unions could not picket to force Colson's adoption of the Master Agreement without violating Section 8(b)(4)(A) unless, as the petitioning Unions contend, the construction industry proviso to Section 8(e) immunizes coercive conduct otherwise violative of Section 8(b)(4)(A). We show now that the Board properly rejected this contention, and concluded that Section 8(b)(4)(A) interdicts the denominated conduct in a construction industry context.

1. *Section 8(b)(4)(A) applies to coercive attempts by the building trades to obtain employer agreements to cease doing business*

Section 8(b)(4)(A) of the amended Act proscribes coercive union activity to force upon an employer "any agreement which is prohibited by section 8(e)." The latter section, with two limited exceptions, creates a sweeping ban on *any agreement*, whether ex-

press or implied, by which an employer becomes committed to cease doing business with "any other person." The two exceptions, embodied in separate provisos to Section 8(e), differ markedly in scope (see *supra*, pp. 9-10).

In the garment industry, persons in certain relationships are excluded from the definitional phrases of both Section 8(e) and Section 8(b)(4)(B), so that unions dealing with such persons may not only make restrictive agreements but also coerce a cessation of business, whether the coerced employer has or has not contractually committed himself to boycott and whether the union is seeking an immediate severance of business relations with named individuals or a long-term boycott of an entire category of other persons. The construction industry proviso, by contrast, simply makes Section 8(e) inapplicable to "an agreement" relating to the contracting or subcontracting of construction site work. Thus, building contractors and unions who agree upon such restrictions do not thereby commit an unfair labor practice, and the agreement reached is not "unenforcible and void" but may be enforced by any conduct not violative of Section 8(b)(4)(B)—for the latter section is fully applicable to construction unions. Not only does this proviso not mention 8(b)(4)(B) as does the garment industry proviso, but the authoritative legislative history is explicit: "Since the proviso does not relate to Section 8(b)(4), strikes and picketing to enforce the contracts excepted by the proviso will continue to be illegal under Section 8(b)(4) whenever the *Sand Door* case (357 U.S. 93) is appli-

cable." [9] Moreover, "it [the proviso] is not intended to change the law . . . with respect to the legality of a strike to obtain such a contract." [10]

The construction industry proviso, then, "permits the making of *voluntary* agreements." [11] As Senator Kennedy, the conference chairman, stated in his analysis of the conference bill prior to its adoption, the proviso "is intended to preserve the present state of the law . . . with respect to the validity of agreements. . . . by which a contractor in the construction industry promises not to subcontract work on a construction site to a nonunion contractor" (105 Cong. Rec. 17900, II Leg. Hist. 1433). This was necessary, he explained, "to avoid serious damage to the pattern of collective bargaining in [this] industry" (105 Cong. Rec. 17899, II Leg. Hist. 1432). As was pointed out in a 1950 study of building trades bargaining in the 12 counties of southern California, where a master agreement establishing basic employment standards has been in effect since 1941 in

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[9] Analysis of Senator Kennedy during debate on the conference bill, 105 Cong. Rec. 17900, II Leg. Hist. 1433 ("Leg. Hist." refers to the two-volume work, *Legislative History of the Labor-Management Reporting and Disclosure Act of 1959* (G.P.O. 1959)). See also the report of the House conferees, H.R. Rep. No. 1147 on S. 1555, 86th Cong., 1st Sess., p. 39, I Leg. Hist. 943.

[10] Analysis of Senator Kennedy, *supra*, n. 9.

[11] Statement of Chairman Barden of the House Labor Committee, a member of the conference committee where the proviso originated, in presenting the conference report to the House (emphasis added), 105 Cong. Rec. 18128, II Leg. Hist. 1715.

which 19 building trades unions participate together with the 10 building trades councils and the major contractors' associations, "for the well-established employers, it is also important to have a floor under competitive labor costs." [12] The structure of the industry, with subcontracting a customary way of doing business, leads many employers to favor subcontracting clauses as a means of undergirding such a "floor." The southern California master labor agreement referred to above contains such a clause,[13] similar to the clause that the petitioner Unions sought to force upon Colson, as a result of which "any subcontractor [of a signatory contractor] who attempts to depart from the established union standards faces cancellation of his contracts and an immediate loss of business." 70 Monthly Labor Review at 17. On the other hand, if the contractor is unwilling in the circumstances to cancel the subcontract, or if he lets a subcontract to one who refuses to become bound by the master labor agreement, then the signatory contractor faces suit by the unions for specific performance, with an interruption of work on his project occasioned by a change of subcontractors, and perhaps a damage suit by the ousted subcontractor.

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[12] Pierson, *Building-Trades Bargaining Plan in Southern California*, 70 Monthly Labor Review 14 (U.S. Dept. of Labor, B.L.S., 1950).

[13] "That if the contractors, parties hereto, shall subcontract work as defined herein, provision shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement." Quoted in 70 Monthly Labor Review at 17.

This bargaining pattern, with these effects, Congress believed legitimate and left lawful, so long as the restrictive agreement represents the free choice of the parties.

The limited reach of the construction industry exemption was intentional. During the 86th Congress, while the committee of conference was considering the House- and Senate-passed bills (neither of which made any special provision for construction industry secondary boycott agreements), a group of Senate conferees put forth a proposal to accord the construction industry the same broad exception subsequently granted the garment industry. In that same proposal, S. Res. 181, 86th Cong., 1st Sess., 105 Cong. Rec. 17332-17333, II Leg. Hist. 1382-1383, the clause in Section 8(b)(4)(A) here found violated first appeared. The conference committee and subsequently the Congress adopted the proposed amendment to 8(b)(4)(A), but, as we have seen, did not adopt the proposed immunization of secondary pressure by building trades unions. Moreover, at the same time that it adopted the 8(b)(4)(A) clause, the conference committee dropped from the amended 8(b)(4)(B) the phrase "or agree to cease" which had appeared in the House-passed bill. Explaining this deletion, the House managers stated in their report accompanying the conference bill that the restrictions thereby imposed were included in "the other provisions" dealing with secondary boycott agreements "and therefore their retention in section 8(b)(4)(B) would constitute a duplication of language" (H.R. Rep. No. 1147 on S. 1555, 86th

Cong., 1st Sess., p. 38, I Leg. Hist. 942). The "other provisions" referred to can only be Section 8(b)(4)(A), for only that section (and not 8(e)) shares with 8(b)(4)(B) the requirement of coercive means. Therefore, if the deleted phrase would have been "a duplication," the reach of 8(b)(4)(A) must be coextensive with that of 8(b)(4)(B), and as we have shown, the latter provision has always been fully applicable to construction unions.

The special treatment accorded the construction industry by Section 8(e)—authorization to enter into and to enforce subcontracting agreements so long as the unions refrain from coercive economic pressures—is comparable in nature to the special treatment of that industry elsewhere in the amended Act. By the new Section 8(f), Congress likewise gave recognition to the special circumstances pertaining in the industry and differentiating it from manufacturing and sales enterprises. Section 8(f) permits construction unions and employers to enter into prehire collective bargaining agreements and to make the union-security provisions of their contracts effective after only 7 days, practices which would otherwise constitute employer violations of Section 8(a)(1), (2), and (3) and union violations of Section 8(b)(1)(A) and (2). Again, the permission thus given is permission to enter into voluntary agreements. As the legislative history makes clear, Congress did not intend by Section 8(f) to legitimize strikes or picketing to coerce an employer's acceptance of these agreements. H.R. Rep. No. 1147 on S. 1555, 86th Cong., 1st Sess., p.

42, I Leg. Hist. 946 ("Nothing in [8(f)] is intended . . . to authorize the use of force, coercion, strikes or picketing to compel any person to enter into such prehire agreements."); 105 Cong. Rec. 18128, II Leg. Hist. 1715 [14]; cf., *Sperry* v. *Local Union No. 562, United Association,* F. Supp. (W.D. Mo.), 52 LRRM 2673, 2676-2677 (holding that Section 8(f) provides no defense to an 8(b)(7)(C) charge); *N.L.R.B.* v. *Int'l Hod Carriers Union, Local 1140,* 285 F.2d 397, 403 (C.A. 8), cert. denied, 366 U.S. 903.

In amending Section 8(b)(4)(A) and adding 8(e), Congress sought to broaden and tighten the statutory ban on coercive involvement of neutral employers in labor disputes not their own. Nothing in the amendments adopted nor in their legislative history suggests that in so doing, Congress meant to sanction any conduct previously unlawful. Yet, if the first proviso to 8(e) creates an immunity also from the specific inhibition of Section 8(b)(4)(A), it thereby exempts conduct which was already prohibited by the more general secondary boycott provision of the 1947 Act. For, as we shall show hereafter (Part I. D., pp. 37-44), strikes or picket-

[14] Cong. Barden reading into the record a colloquy on the Senate floor in 1958 as to the interpretation to be given a provision then under consideration similar to 8(f). Senator Kennedy there stated, "nor was it the intention of the committee to authorize a labor organization to strike, picket, or otherwise coerce an employer to sign a prehire agreement where the majority status of the union had not been established. The purpose of this section is to permit voluntary prehire agreements."

ing to force a building contractor to cease doing business with a group of other persons, by the device of exacting his legally-enforceable contractual commitment to do so, had been held unlawful under Section 8(b)(4)(A) of the Taft-Hartley Act.[15] Thus, in amending Section 8(b)(4)(A) in 1959, Congress made explicit what "the process of litigating elucidation" (*Int'l Ass'n of Machinists* v. *Gonzales*, 356 U.S. 617, 619) revealed to have been implicit in the more general provision of the prior law. And in enacting the first proviso to Section 8(e), Congress avowedly did not intend "that this proviso should be construed so as * * * to remove the limitations which the present law imposes with respect to such agreements. * * * It is not intended that the proviso change the existing law * * * with respect to the legality of a strike to obtain such a contract." H.R. Rep. No. 1147 on S. 1555, 86th Cong., 1st Sess., pp. 39-40, I Leg. Hist. 943-944. In sum, picketing and other proscribed conduct to exact an employer's consent to a contract clause limiting the persons with whom he may continue to contract was unlawful under the general cease-doing-business provisions of the 1947 Act, and Congress in 1959, while carrying forward those provisions, in addition created a separate unfair labor practice specifically

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[15] *N.L.R.B.* v. *Local 47, Int'l Brotherhood of Teamsters*, 234 F.2d 296 (C.A. 5); *Bricklayers, Masons and Plasterers Int'l Union (Selby-Battersby)*, 125 NLRB 1179; and see discussion of the *Sand Door* case, 357 U.S. 93, *infra*, p. 42. The statutory provision involved in those cases was transferred by the 1959 amendments to Section 8(b)(4)(B) of the Act.

expressing its condemnation of coercive tactics to secure *any* secondary boycott agreement. Since Congress did not mean the 8(e) proviso to affect the legality of these tactics as employed in the construction industry, their use by the building trades must now run afoul of both the general and the specific statutory prohibitions.[16]

Moreover, even apart from the applicability here of Section 8(b)(4)(B), the interpretation of the 8(e) proviso for which the Unions contend would produce results inconsistent with other provisions of the Act. Section 8(b)(3) and 8(d) establish the duty of a majority representative to bargain in good faith about "wages, hours, and other terms and conditions of employment"—the so-called "mandatory" subjects of bargaining. As to these subjects, a majority representative may insist upon its position. Conversely, the duty to bargain about matters within the mandatory area carries with it the obligation to refrain from insisting upon inclusion in a contract of matters outside that area, for "such conduct is, in substance, a refusal to bargain about the subjects that are within the scope of mandatory bargaining." *N.L.R.B.* v. *Wooster Div. of Borg-Warner Corp.*, 356 U.S. 342, 349. A contract clause limiting the persons with whom the employer may do business, contrary to the petitioner Unions' assertion (Brief, pp. 17-21), is not a mandatory subject of bargaining

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[16] Just as do the same tactics in pursuit of secondary subcontracting clauses in a different industrial context. *Highway Truck Drivers* v. *N.L.R.B.*, 302 F.2d 897 (C.A.D.C.).

within the meaning of Section 8(d).[17] Insofar as a construction industry union and employer are concerned, it is at best a permissible subject of bargaining, one as to which "each party is free to bargain or not to bargain, and to agree or not to agree" *N.L.R.B.* v. *Wooster Div. of Borg-Warner Corp.*, 356 U.S. 342, 349.[18] The secondary subcontractor clause, by definition, does not relate to "wages, hours, and other terms and conditions of employment" of the contractor's employees. It does not regulate the relations between the contractor as employer and his employees. It deals, instead, only with relations between the contractor and other employers. It is, therefore, as a regulation of third-party relationships extrinsic to the employment relation, a clause of precisely the type that *Borg-Warner* held non-mandatory (356 U.S. at 349-350).

The proviso "permits the making of voluntary agreements" (*supra*, p. 19). Conversely, it does not authorize an involuntary agreement, the promise given under duress, in response to coercion. An

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[17] Such a clause is to be distinguished from the typical "primary" subcontracting clause (see pp. 28-30, *infra*).

[18] In this industry, owing to the 8(e) proviso, the secondary subcontractor clause, like the "ballot" and "recognition" clauses in the *Borg-Warner* case, "is lawful in itself [and] would be enforceable if agreed to by the [employer]. But it does not follow that, because the [union] may propose these clauses, it can lawfully insist upon them as a condition to any agreement." 356 U.S. at 349. As to industries not covered by the 8(e) proviso, such a clause is not even a permissible subject of bargaining, but an illegal clause (see pp. 28-30, *infra*).

agreement of this sort, not being immunized by the proviso, falls under the ban of 8(e) proper. It is, therefore, "an agreement prohibited by Section 8(e)" within the meaning of Section 8(b)(4)(A). As the Board concluded, "the construction exemption in Section 8(e) was not intended to remove from the reach of [any part of] Section 8(b)(4) picketing and other proscribed conduct which is designed to secure such contracts as are before us in this case." (R. 57). This reading, in the Board's view, "gives hospitable scope to the competing interests which Congress here sought to balance. To construe the statute as condemning coercive enforcement of agreements of the type here involved but condoning coercion as a means of obtaining such agreements would in our view be to pay observance to slavish literalism and to frustrate the Congressional objective. The Supreme Court periodically reminds us . . . that words used in a statute should not be literally construed, even where their literary purport is clear, if such construction would lead to absurd and incongruous results plainly at variance with the policy of the legislation as a whole." (*Ibid.*). Cf., *Int'l Longshoremen's & Warehousemen's Union* v. *Juneau Spruce Corp.*, 189 F.2d 177, 185 (C.A. 9), aff'd, 342 U.S. 237, 243 ("literalness is no sure touchstone of legislative purpose").

2. *Article I-C of the Arizona Master Labor Agreement is an agreement to cease doing business within the intendment of Section 8(e) of the Act*

Section 8(e) literally makes unlawful any agreement between a union and an employer whereby the

employer agrees to cease doing business with any other person. This section, however, dovetails with Section 8(b)(4)(B) and, like 8(b)(4)(B), must be read to cover only "secondary" activity. "The question * * * is whether a particular agreement is fairly within the intendment of Congress to do away with the secondary boycott." *District 9, Machinists* v. *N.L.R.B.*, 315 F.2d 33, 36 (C.A.D.C.).

Thus, as the Unions correctly point out (Brief, p. 19), in the Board's view, a contract clause basically intended to preserve the work opportunities of employees in the unit covered by the contract is primary in nature and therefore outside the scope of Section 8(e), even though an incidental effect of the clause may be to limit the employer's freedom to do business with others.[19] On the other hand, if the basic target of the clause is the employment conditions of the employees of another employer, then the clause must be viewed as secondary in nature and therefore within the scope of Section 8(e), even though an incidental effect of the clause may be to benefit employees in the unit.[20] As the Board went

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[19] This view comports with the settled law relating to the original secondary boycott provisions of the Act. See, e.g., *Local 761, I.U.E.* v. *N.L.R.B.*, 366 U.S. 667, 672; *N.L.R.B.* v. *Denver Bldg. & Construction Trades Council*, 341 U.S. 675, 687-688.

[20] The ultimate purpose of most unlawful secondary boycott activity is to promote better working conditions, higher wages, and more work for members of the union generally. For it would be absurd even to suggest that a union would pursue such a course out of sheer caprice, and with nothing to gain but the bare cessation of business relationships be-

on to explain in the opinion from which the Unions reprint an excerpt (*Ohio Valley Carpenters District Council*, 136 NLRB 977, 49 LRRM 1908):

> [Contractual restrictions on having done elsewhere work usually performed by unit employees undoubtedly impinge upon an employer's freedom to engage in business with others.] But where they do no more than define and reserve for the exclusive performance of employees in a bargaining unit work of a kind that has traditionally been performed in that unit, they have a different function from the contracts that were the targets of 8(e). Restrictions designed to confine work to unit employees are immediately related to terms and conditions of employment *within the unit.* They anticipate no work to be performed by persons other than employees of the immediate employer. Their sole, direct, and primary aim is to protect and preserve work and therefore jobs for employees within the bargaining unit. In these respects limited restrictions of that character are quite different in purpose and intent from the "hot goods" clauses 8(e) was designed to ban—that is, the blacklisting of specified employers or classes of employers be-

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tween employers. "A finding of an illegal intermediate object is all that is required." *Amalgamated Meat Cutters, etc.* v. *N.L.R.B.*, 237 F.2d 20, 25 (C.A.D.C.), cert. denied, 352 U.S. 1015. If ultimate economic motivation established the legality of a union's conduct, the secondary boycott proscriptions of the Act would become a dead letter. As this Court has succinctly stated, "the prohibition of section 8(e) is a broad one. Agreements of this kind, whether express or implied, are not made lawful by economic necessity." *N.L.R.B.* v. *Amalgamated Lithographers*, 309 F.2d 31, 36 (C.A. 9), cert. denied, 372 U.S. 943.

> cause their products or labor policies are objectionable to the union. A "hot goods" clause anticipates work to be performed by persons other than the employees of the immediate employer. Without such anticipation the "hot goods" clause serves no purpose, for its interest is to empower the union to regulate the dealings of the immediate employer with others by dictating with what class of other employer the immediate employer may deal, or under what conditions. In short, it is with work or conditions of work outside the contract's bargaining unit that "hot goods" clauses are immediately concerned.

In short, the touchstone of a clause's legality must be "whether the contract provisions in question extend beyond the employer and are aimed really at the union's difference with another employer." *Local 636, Plumbers* v. *N.L.R.B.*, 278 F.2d 858, 864 (C.A.D.C.). Like the "hot goods" clause described above, the subcontractor clause is clearly secondary which limits not the fact of subcontracting—either prohibiting it outright or conditioning it upon, e.g., current full employment of the signatory employer's employees—but *the persons with whom* the signatory employer may subcontract. Its purpose is a termination of business dealings between the signatory employer and others of whom the union does not approve or with whom it has a dispute. The secondary subcontractor clause, therefore, like the "hot goods" clause, falls within the scope of Section 8(e). *District 9, Machinists* v. *N.L.R.B.*, *supra*, 315 F.2d at 36-37; *Highway Truck Drivers, Local 107* v. *N.L.R.B.*,

302 F.2d 897 (C.A.D.C.); cf., *N.L.R.B.* v. *Int'l Union of Operating Engineers*, 293 F.2d 319, 323 (C.A. 9).[21]

The Unions' attempt (Brief, p. 20) to justify their contract clause and their picketing by invoking such cases as *Local 24, Teamsters* v. *Revel Oliver*, 358 U.S. 283, founders on the fact that it is the function or focus of a clause that determines whether it is "primary"—a mandatory subject of bargaining for which strike pressure may be employed—or "secondary" and so within the ambit of 8(e).[22] For *Oliver* illustrates the type of work-protection purpose which, as we have just shown, is primary and protected though an incidental effect is a limitation on the contracting employer's unfettered freedom to contract with others. *Oliver* involved the applicability of state anti-trust laws to a collective bargaining contract clause setting minimum rental rates for any truck "leased to a [signatory] carrier by an owner who drives his vehicle in the carrier's service," and only at such times, the driver-owner then being considered an employee of the carrier, with his wages, hours, and working conditions those established by the contract (358 U.S. at 284-285, 286-287). The union had sought, by this clause, to prevent the *carriers* paying below-cost rental fees as a device by

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[21] Indeed, the very terminology of the first proviso to Section 8(e) indicates congressional belief that in order to save voluntary subcontractor clauses in the construction industry from the 8(e) ban it was necessary specifically to describe them.

[22] And likewise 8(b)(4)(B), see *infra*, pp. 39-42.

which, in effect, to pay wages lower than their contract scale (*id.* at 291-292). Because this objective bore such an intimate relation to the carrier wage scale set by the contract and to the protection of the carriers' regular employees' jobs against a possible reduction in number were the carriers able to operate at lower cost by substituting owner-drivers on inadequate rental fees, the Court found the rent-fixing clause within the area of bargaining made mandatory by federal law, hence immune to state regulation (*id.* at 293-295, see also, *U.S.* v. *Drum*, 368 U.S. 370, 382 n. 26). In short, *Oliver* teaches that a contract clause designed to protect the wages and work of the employees of the contracting employer—the *only* employer to whom the challenged clause referred—is a mandatory subject of bargaining. Manifestly, the case neither holds nor implies a contract clause primary and bargainable which seeks to determine conditions of work outside the contract's bargaining unit by dictating with what class of other employer the contracting employer may do business.[23]

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[23] The other cases relied on by the Unions to show the legitimacy of their insistence on Article I-C of the Master Agreement similarly fall short of the mark (Brief, pp. 19-21). In a recently issued opinion denying a petition for rehearing, the court in *Deaton Truck Line, Inc.* v. *Local 612, Teamsters*, F.2d (C.A. 5), 51 LRRM 2552, opinion modified and reh. denied, March 14, 1963, 52 LRRM 2728, 2729, withdrew the language quoted by the Unions (Brief, p. 20) and expressly refused to pass on questions of the relationship between the contract clause in dispute and the wages established by the contract. In any event, *Deaton* was an action under Section 301 of the Act to compel arbitration

In the context presented in this case, where the subcontractor clause is sought to be imposed upon a

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of a dispute over the meaning of a contract clause. The possible applicability of Section 8(e) was apparently not raised; it is nowhere mentioned by the court. The Board does not, of course, deny a union's "interest" in maintaining and protecting its area wage standards, but importance to the union is not a criterion on which Board or court decisions may be rested where, as with the closed shop or unlimited recognitional picketing or—here—secondary boycott agreements, Congress has determined that interests may not be advanced or advanced by designated means. Hence, however "legitimate" a union's interest in area standards, it may not be advanced by contractual arrangements outlawed by Section 8(e).

The Board's decision in *Local Union No. 741, (Keith Riggs Plumbing)*, 137 NLRB No. 121, 50 LRRM 1313, is likewise inapposite, for the question at issue there was not the lawfulness of standards picketing, whatever its effect—no provision of the Act renders this unlawful—but simply whether the union had transgressed Section 8(b)(7)(C) by picketing for organizational or recognitional purposes.

Finally, *Order of R.R. Telegraphers* v. *Chicago & Northwestern Ry. Co.*, 362 U.S. 330, decided under the Railway Labor Act, and the Board's subsequent decision in *Town & Country Mfg. Co.*, 136 NLRB No. 111, 49 LRRM 1918, enforced, April 29, 1963, No. 19679, F.2d (C.A. 5), 53 LRRM 2054, finding the same principle embodied in Section 8(d) and 8(a)(5) of the National Labor Relations Act, as amended, are equally irrelevant here. That an employer is dutybound to bargain with the representative of his employees before abandoning or otherwise ceasing himself to perform a customary function, with resulting loss of employment to the employees, is a consequence of his duty to bargain about "wages, hours, and other terms and conditions of employment." As we have shown, *supra*, pp. 25-26, the subcontractor clause limiting not the fact or practice of subcontracting but the persons with whom the signatory employer may deal is unrelated to these topics of mandatory bargaining.

general contractor for whom subcontracting is the normal mode of carrying on his enterprise, it cannot cogently be suggested that, as the Unions argue, Article I-C represents a legitimate, primary attempt to remove the economic incentive for contracting out bargaining unit work, or as the Unions phrase it, "dodging the collective bargaining agreement" (Brief, pp. 18, 19). Article I-C is not limited, as they assert (Brief, p. 19), so as to apply only when work is subcontracted which would otherwise be performed by the general contractor's employees. On the contrary, it applies to all "subcontract construction work as defined hereafter in Article III of this Agreement," and Article III is phrased in the broadest terms to include anything that could be thought of as construction.[24] Moreover, Article I-C goes on to

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[24] Thus, Article III, entitled "Work Covered," provides:

"A. The Construction of, in whole or in part, or the improvement or modification thereof, including any structures or operations which are incidental thereto, the assembly, operation, maintenance and repair of all equipment, vehicles and other facilities used in connection with the performance of the aforementioned work and services and including, but not limited to, the following types or classes of work:

"B. Street and Highway work, grading and paving, mechanical land leveling, excavation of earth and rock, grade separations, elevated highways, viaducts, bridges, abutments, retaining walls, subways, airport grading, surfacing and drainage, electric transmission line and conduit projects, water mains, pipe lines, sanitation and sewer projects, dams, tunnels, shafts, aqueducts, canals, reservoirs, intakes, channels, levees, dikes, revetments, quarrying of breakwater or riprap stone; foundations, pile drivings, piers, lock, dikes; river and harbors projects; breakwaters, jetties and dredging; warehouses, shops and yards, the construction, erection,

define the "subcontractor" who must observe "the terms of this Agreement" as "any person, firm or corporation who agrees under contract with the general contractor or his subcontractor to perform on the job site *any part or portion of the construction work covered by the prime contract* * * *." Colson employs only carpenters and laborers, subcontracting all other kinds of work required by its prime contracts (Tr. 177). Article I-C would thus have precluded Colson from continuing to do business with any subcontractor not bound or willing to become bound by "the terms of this Agreement" even though that subcontractor could not be "competing" with Colson's own employees. In short, Article I-C would have compelled Colson "to boycott another employer for reasons not strictly germane to the economic integrity of the principal work unit" *District 9, Machinists* v. *N.L.R.B.*, 315 F.2d 33, 36 (C.A.D.C.).

The Unions urge that Article I-C means only that Colson would have been responsible "to see to it that the wage and working standards set out in the Agreement shall be complied with" by its subcontractors (Brief, p. 19). The description does not fit, we submit, a clause requiring of all subcontractors

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alteration, repair, modification, demolition, addition or improvement in whole or in part of any building structure, including oil and gas refineries and incidental structures, also including any grading, excavation, or similar operations which are incidental thereto, or the installation, operation, maintenance and repair of equipment, and other facilities used in connection with the performance of such building construction.

"C. * * * * *"

"the observance . . . *of the terms* of this Agreement." This is not, on its face, simply a provision to make certain that the subcontractor maintains labor standards commensurate with those of the signatory general contractor. Here, as in *N.L.R.B.* v. *Bangor Bldg. Trades Council*, 278 F.2d 287 (C.A. 1), where the clause sought to be enforced provided that "this Agreement binds all the subcontractors as well as the general [signatory] contractor," it may well be said that the clause in question "is plainly broader than the payment of wages. It contains no exceptions, but embraces all the provisions of the [general's] contract. *Hence it includes union recognition.*" *Bangor Bldg. Trades Council*, 278 F.2d at 288, 290, emphasis added. And furthermore, again as in *Bangor Bldg. Trades Council, supra* at 290, the Unions "were not unaware of this." At their meeting with Colson on January 12, where Colson was given and asked to sign the Master Agreement, much of the discussion concerned its impact upon the Company's existing subcontract commitments with nonunion subcontractors, and a proposal that the Unions permit completion of a partially-built church with nonunion subcontractors then on the job if the two school construction projects were made the "breaking-off point" when the Company would convert to all-union subcontractors. Indeed, the Unions appear to concede the point: "much of the conversation concerned a 'breaking off' point, that is a point in time in the future when the subcontractor clause (Art. I.C.) in the Arizona Master Labor Agreement would be effective." (Brief, p. 7).

D. *The Unions' picketing for the Master Agreement also violated Section 8(b)(4)(B) of the amended Act*

Section 8(b)(4)(B) of the amended Act, to the extent relevant here, carries forward the provisions of the original secondary boycott section, Section 8(b)(4)(A) of the 1947 Act. As already noted, *supra*, p. 9, these original provisions proscribed certain conduct, including picketing, where "an object" was to force a neutral person—one with whose labor practices the union had no quarrel—to "cease doing business" with another person of whom, for whatever reason, the union disapproved. The prohibition thus pronounced did not depend upon the existence of an active labor dispute between the union and the disapproved, "primary" employer,[25] nor was it relevant that the union had other or alternative ends in view when it struck.[26] Likewise, neither the fact that the union and struck employer were parties to a contract giving the union the right to demand the cessation of practices against which it struck, or sanctioning the unit employees' right to refuse to

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[25] *N.L.R.B.* v. *Washington-Oregon Shingle Weavers,* 211 F.2d 149, 152-153 (C.A. 9); *N.L.R.B.* v. *Local Union No. 751, Carpenters,* 285 F.2d 633, 639 (C.A. 9); *N.L.R.B.* v. *Local 11, Carpenters,* 242 F.2d 932, 934-935 (C.A. 6); *Local 1976, Carpenters,* 113 NLRB 1210, 1211-1212, 1213-1214, enforced, 241 F.2d 147, 154 (C.A. 9), aff'd, 357 U.S. 93.

[26] *N.L.R.B.* v. *Denver Bldg. & Construction Trades Council,* 341 U.S. 675, 689; *N.L.R.B.* v. *Local 74, Carpenters,* 341 U.S. 707, 713; *N.L.R.B.* v. *Int'l Union of Operating Engineers,* 293 F.2d 319, 322-323 (C.A. 9).

participate therein,[27] nor the fact that the union abandoned its coercive tactics short of achievement of its goal [28]—neither of these states of affairs militated against a Board finding of illegality in the coercion actually employed, for "an" objective plainly proscribed. Accordingly, on settled law, if the Board properly found that an object of the Unions' picketing was a cessation of business between Colson and its nonunion subcontractors, then "an object" of the Unions' picketing was unlawful, and insofar as that object was concerned Colson was a "neutral," [29] notwithstanding that the picketing had also recognitional and/or organizational objects, and regardless of the fact that the Unions may have had no active dispute with Colson's nonunion subcontractors. Similarly, it is immaterial that the Unions abandoned their picketing before having achieved their purpose of procuring Colson's assent to the Master Agreement; 8(b)(4)(B) does not presuppose that the union exerting unlawful pressure upon a

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[27] *Local 1976, Carpenters* v. *N.L.R.B.*, 357 U.S. 93, 106; *N.L.R.B.* v. *Int'l Union of Operating Engineers*, 293 F.2d 319, 323 (C.A. 9); *N.L.R.B.* v. *Bangor Bldg. Trades Council*, 278 F.2d 287, 290 n. 4 (C.A. 1); *N.L.R.B.* v. *Washington-Oregon Shingle Weavers*, 211 F.2d 149, 151 (C.A. 9). For a like holding under the amended 8(b)(4)(B), see *New York Mailers* v. *N.L.R.B.*, F.2d (C.A.D.C.), 52 LRRM 2433, 2434 (decided February 14, 1963).

[28] *N.L.R.B.* v. *Local Union No. 751, Carpenters*, 285 F.2d 633, 637-638 (C.A. 9); cf., *Local 1976, Carpenters* v. *N.L.R.B.*, 357 U.S. 93, 97 n. 2.

[29] Cf., *Local 636, Plumbers* v. *N.L.R.B.*, 278 F.2d 858, 864 (C.A.D.C.).

neutral intends to maintain its strike or picketing indefinitely (Union Brief, p. 16). See *N.L.R.B.* v. *Local Union No. 751, Carpenters*, 285 F.2d 633, 637-638 (C.A. 9).

That Article I-C of the Master Agreement for which the Unions picketed embodies a "cease doing business" objective would scarcely seem debatable. As we have just shown, once a general contractor becomes signatory to the Agreement, he is precluded "by its very terms" (R. 55) from dealing with subcontractors who will not likewise abide by its terms; that is, he must transfer his subcontracts to employers who will comply with the Agreement. Thus a union that pickets a general to require acceptance of such a clause is coercing him for the purpose of creating pressure on another, who must acquiesce in the union's demands or lose his subcontracts.

As the Board pointed out, "picketing in these circumstances was held to be for an object of forcing an employer to cease doing business within the meaning of Section 8(b)(4)(A) of the Act, prior to the 1959 amendments." (R. 55). *N.L.R.B.* v. *Local 47, Int'l Brotherhood of Teamsters*, 234 F.2d 296 (C.A. 5), enforcing 112 NLRB 923, held violative of then Section 8(b)(4)(A) picketing of general contractors in the construction industry to force their acceptance of a contract clause providing that "any subcontractor engaged to perform work covered by this agreement for employer shall assume all terms and conditions of this agreement" (*id.* at 298). The union, having sought without success to organize building

industry truckdrivers in the area, most of whom were employed by subcontractors, set out to attain this ultimate objective by negotiating with the general contractors an agreement covering truckdrivers and containing the subcontractor clause quoted above (*id.* at 297-298). One contractor contacted was amenable to those portions of the agreement establishing conditions of employment for his driver employees, and the other explained to the union that he did not employ drivers; both contractors, however, resisted signing the subcontractor clause (*id.* at 298, 299). The union thereupon picketed building projects of each contractor, one of whom capitulated and signed the contract, complete with subcontractor clause (*id.* at 299). Since an object of the union's conduct in seeking the subcontractor clause was to force the contractors to cease doing business with any subcontractor who refused to abide by the truckdrivers agreement, the union's picketing for that object violated the secondary boycott provision of the Act (*id.* at 300-301).

Similarly, in *Bricklayers, Masons and Plasterers Int'l Union* (*Selby-Battersby*), 125 NLRB 1179, 1181-1182, the Board found the secondary boycott provision of the 1947 Act violated by a strike against a union subcontractor, the "admitted purpose" of which was to force the subcontractor to incorporate in its union contracts a clause "admittedly designed to curtail open-shop conditions in the building and construction industry" in the area by requiring the signatory employers to cease doing busi-

ness with nonsignatories.[30] The union's object was unlawful notwithstanding the fact that here (unlike the situation in the *Local 47* case, *supra*) the agreement sought permitted the completion of nonunion jobs already underway and thus would "disrupt secondary relationships at a future time." This was so, said the Board, because "the impact of the strike was nevertheless immediate," and the general contractors with whom Selby was pressured to cease doing business constituted a well-defined, identifiable group.

Indeed, the purpose of a secondary subcontractor clause (or secondary contractor clause, as in *Selby*, *supra*), the very reason why unions desire such provisions, demonstrates that the resort to 8(b)(4) means to extract an employer's assent was to force or require him "to cease doing business with any other person" within the meaning of the original secondary boycott provision of the statute. That purpose is a boycott of the persons in the blacklisted group, to induce their conformity to the union's wishes so that they may become "delisted." Such a clause was not in itself a violation of the Act not because it did not contemplate an interruption of

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[30] The clause read in relevant part: "This agreement shall not be construed to require any worker to work with non-union workmen engaged in construction, nor to work for members of the parties of the first part on any building or job for any firm or person having construction work done in the Baltimore area by non-union workmen, provided . . . the union of the trade in which such non-union men are working is . . . affiliated with the Building and Construction Trades Department of the AF of L, and has a similar agreement with a recognized association of employers." (125 NLRB at 1181.)

business relationships—manifestly, it did—but because it did not comprehend the prohibited means. Just as an employer could lawfully agree to boycott others, a union could seek his agreement by persuasion or even by coercion, so long as it refrained from the specifically prohibited means. But if an employer was unwilling to agree, the union that struck or picketed to force him to do so thereby deprived him of "freedom of choice at the time the question whether to boycott or not [arose] in a concrete situation calling for the exercise of judgment on a particular matter of labor and business policy" *Local 1976, Carpenters* v. *N.L.R.B.*, 357 U.S. 93, 105. It would be idle to suggest that to the building contractor who lives by subcontracting there can be anything abstract or contingent about a legally binding agreement to boycott a category of subcontractors; once entered into, it exercises a continuing constraint, requiring him to desist from letting subcontracts to those on the blacklist. Among the "legal radiations" [31] of the agreement is its specific enforceability, with the result that, by virtue of its original coercion the union has successfully embroiled the contractor in a labor dispute not his own. Thus, compliance with such an agreement by one whose assent would not have been given but for the pressure of picketing or a strike would represent the "transmi[ssion] to the moment of boycott, through the contract, [of] the very pressures from which Congress ha[d] determined to relieve secondary employers" *Local 1976, Carpenters, supra,* at 106.

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[31] *Local 1976, Carpenters, supra,* at 108.

There is no merit to the Union's contention that, as a matter of fact, there were no contractual relationships between Colson and its nonunion subcontractors Schwartz, Riggs, and Haun "which would have been affected by the terms of the [Master] Agreement" had Colson capitulated to the Unions' pressure to sign. In the first place, as indicated above in discussing the *Selby-Battersby* case, there is no reason artificially to limit the concept of a cessation of business to the severance of currently existing contractual relationships. Plainly, where A customarily does business with B (or where A, having done business with B intends and expects to do so again), if A desists from further dealings with B in response to a blacklist, the consequence would be described in ordinary language as a "cessation" of the business relations between A and B. See *N.L.R.B.* v. *Local 9, Wood, Wire & Metal Lathers Union*, 255 F.2d 649, 652-653 (C.A. 4). That the word "refrain" might also apply is inconsequential, for there is no reason to view the two terms as necessarily mutually exclusive. Nor does *Hoffman* v. *Joint Council of Teamsters, No. 38,* F.Supp. (N.D. Cal.), 45 Lab. Cases para. 17,803, hold to the contrary, as the Unions assert (Brief, p. 15). Rejecting the position of the respondent-unions "that the word 'refrain' refers specifically to future conduct, as distinguished from the word 'cease,' which is said to refer only to present conduct," Judge Halbert concluded that there can be contexts in which the words are synonymous. "Unquestionably," he wrote, "the word 'cease' implies that the objective

referred to has been in existence, and is to be stopped." We agree; when A has been doing business with nonunion subcontractors, and that "is to be stopped," then A is to "cease doing business" with the subcontractors.[32] Cf., *United Marine Division, Local 333, ILA*, 107 NLRB 686, 697-698, 708-709; *Amer. Fed. of Radio & Television Artists* v. *Getreu*, 258 F.2d 698, 700-701 (C.A. 6).

In any event, Colson had "existing" subcontracts with each of the named subcontractors during the period of picketing. Schwartz had a subcontract on the Yellow Front project, where he worked during the picketing (Tr. 142, 143, 144); Haun had subcontracts on both the Yellow Front project and the two schools (the latter entered into in December, 1960), worked at Yellow Front during picketing, had to make special arrangements for the delivery of materials to the schools because his supplier's deliverymen would not cross the picket line (Tr. 122, 126-129, 132); Riggs had the plumbing subcontract on the two schools and his men worked there during the picketing (Tr. 208, 53, 60). And assuming with the Unions that "the rights and liabilities of the sub-

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[32] In the *Hoffman* case, a proceeding for preliminary injunction under Section 10(1) of the Act, Judge Halbert found certain contract clauses illegal under Section 8(e), and others not thus unlawful, according to whether the language employed "could affect firms presently doing business with the [contracting] employers." In the subsequent Board decision on the merits, *Joint Council of Teamsters No. 38*, 141 NLRB No. 14, 52 LRRM 1322, on a similar analysis the Board found all of the challenged clauses prohibited by Section 8(e).

contractors [were] already fixed by such existing subcontracts" so that Colson could not compel any changes therein (Brief, p. 15), the conclusion follows that had Colson then succumbed and signed, it would have had no choice but to break the existing subcontracts. The Unions would then have been entitled to specific performance of the employer obligation in Article I-C to see that "the terms" of the Master Agreement "extend to and bind such construction subcontract work [by] provisions . . . in such subcontract . . ."; if Colson could not have performed affirmatively, its only option would have been a termination of the subcontracts.

Finally, it avails the Unions nothing that the Master Agreement has no provisions relating specifically to plumbers and brick masons. It may be that the three subcontractors, Schwartz, Riggs and Haun, employed no persons in any of the classifications set forth in Appendixes A-D to the Master Agreement, so that specific craft provisions in the Agreement and Appendixes would have no impact on them. The contract's general provisions, comprising the greater bulk of the agreement, were nonetheless fully applicable.[33] Moreover, that the Unions themselves recognized the applicability of the Agreement to contractors and workmen outside the four basic trades

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[33] See, e.g., the provisions of Article I-C itself, Article III ("Work Covered"), Article IV ("Classifications"), Article V ("Procedure for Settlement of Disputes and Grievances"), Article VII ("Apprentice Training"), Article VIII ("Modification"), Article XIV ("Expense Allowance"), Article XV ("Health and Welfare"), (G.C. Exh. 44).

is demonstrated by the Agreement itself: Article XII, entitled "Additional Contracting Unions," states the matter clearly:

> The Unions will make every effort *to bring all crafts* affiliated with the Building and Construction Trades Department of the American Federation of Labor-Congress of Industrial Organizations *under the terms and provisions of this Agreement*, and the Contractors will make every effort to bring *all Contractors performing work* in the State of Arizona *under the terms and provisions of this Agreement.*

In sum, as the Board concluded, the Unions by their picketing sought to force or require Colson's assent to an agreement which "by its very terms would have compelled Colson to cease doing business with Schwartz, Riggs, and Haun, its nonunion subcontractors, if they did not comply with the contract's provisions. All parties recognized that this was the necessary effect of Colson's signing the Master Agreement . . . . and it was intended, we find, that Colson would implement the contract and cease doing business with the above-mentioned nonunion subcontractors." (R. 55). While thus agreeing with the Trial Examiner's finding that "all concerned expected changes in these [subcontractor] relationships once the Master Agreement was signed" (R. 28), the Board was warranted in rejecting his reasoning that since Colson's signing was the immediate objective, enforcement was left to the future (*ibid.*). Here, as in other contexts, the Board may hold one to have intended the natural and prob-

able consequences of his actions. Cf., *N.L.R.B.* v. *Erie Resistor Corp.*, U.S. , 53 LRRM 2121, 2124 (decided May 13, 1963). Reason requires no such artificial separation between the Unions' coercive conduct to obtain the Master Agreement and their ultimate objective vis-a-vis the subcontractors as manifested by Article I-C, and the economic realities commend its rejection. For if the Unions could force the agreement upon Colson, then they could—by lawful means—force his compliance with it, and none could then doubt that the Unions had as a practical matter "transmit[ted] to the moment of boycott, through the contract, the very pressures from which Congress has determined to relieve secondary employers" (*Local 1976, Carpenters* v. *N.L.R.B.*, 357 U.S. 93, 106). To paraphrase Mr. Justice Frankfurter's words in the *Sand Door* case (*ibid.*), the realities of coercion are not altered simply because it is said that the employer is forced to enter into an enforceable engagement rather than forced now to cease doing business with another.[34]

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[34] There is no merit to the Examiner's proposition, relied on by the Unions (Brief, p. 30), that Congress cannot have forbidden under Section 8(b)(4)(B) picketing which it "permitted" under Section 8(b)(4)(A) (R. 28). Even assuming arguendo that an effect of the 8(e) proviso were to render 8(b)(4)(A) inapplicable in the construction context, it is plain that picketing thereby exempted from a prohibition could not aptly be termed "permitted." In other words, by choosing to exclude certain conduct from the ban in one section of the Act, Congress neither gives that conduct affirmative sanction nor manifests an intention to exclude it also from any or all other sections.

II. The Board properly concluded that neither Union violated Section 8(b)(7)(C) of the Act

Section 8(b)(7)(C) of the Act, insofar as here relevant, limits picketing by an uncertified union "an object" of which is forcing an employer to recognize or bargain with it, or the employees to accept or select it as their bargaining representative, "where such picketing has been conducted without a petition under section 9(c) being filed *within a reasonable period of time not to exceed thirty days* from the commencement of such picketing." [35]

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[35] The Section provides, in full:

> (7) to picket or cause to be picketed, or threaten to picket or cause to be picketed, any employer where an object thereof is forcing or requiring an employer to recognize or bargain with a labor organization as the representative of his employees, or forcing or requiring the employees of an employer to accept or select such labor organization as their collective bargaining representative, unless such labor organization is currently certified as the representative of such employees:
>
> * * * *
>
> (C) where such picketing has been conducted without a petition under section 9(c) being filed within a reasonable period of time not to exceed thirty days from the commencement of such picketing: Provided, That when such a petition has been filed the Board shall forthwith, without regard to the provisions of section 9(c)(1) or the absence of a showing of a substantial interest on the part of the labor organization, direct an election in such unit as the Board finds to be appropriate and shall certify the results thereof: Provided further, That nothing in this subparagraph (C) shall be construed to prohibit any picketing or other publicity for the purpose of truthfully advising the public (including consumers) that an employer does not employ mem-

As the Board pointed out, and as the petitioning Association does not here dispute, in the circumstances of this case "the applicable test" of whether either Union violated Section 8(b)(7)(C) "is whether the picketing had been conducted for more than a reasonable time, not to exceed 30 days from the commencement thereof." (R. 58). Since the picketing of *each* Union was terminated within the period permitted by the Act, neither could be found in violation of 8(b)(7)(C) unless each must be held responsible for the other's picketing so that together, in effect, they picketed for more than the permitted 30 days. In agreement with the Trial Examiner, the Board found that the allegation of joint or concerted picketing was not supported by a preponderance of the evidence (R. 58-59, 28-29).

We submit that the Board's conclusion was correct on this record and that the facts stressed by the petitioner Association do not militate against it. In brief, those facts are two: that both Local 1089 and Local 383 were members of the Phoenix Building and Construction Trades Council, and that both were signatory to the Master Agreement. These two circumstances are insufficient to establish that the Unions

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bers of, or have a contract with, a labor organization, unless an effect of such picketing is to induce any individual employed by any other person in the course of his employment, not to pick up, deliver or transport any goods or not to perform any services.

Nothing in this paragraph (7) shall be construed to permit any act which would otherwise be an unfair labor practice under this section 8(b).

were engaged in a joint campaign to wrest recognition from Colson, much less joint picketing. There is no evidence of any Trades Council action germane to the question; its committee to investigate the Carpenters' charge that Colson was "unfair" was not shown to have had any mission other than investigation,[36] and the same is true of the "survey committee" that visited Colson a few days before the January 12 meeting. According to the testimony, the survey committee had nothing to do with recognition but rather gathered information on what construction was being done in the area and by whom (Tr. 296-297, 391-392, 397-398). On January 10, that committee talked with Stevens and set up a meeting with building trades representatives for January 12; the conversation was brief, recognition was not discussed, and Stevens specifically asked that a Carpenters representative be present at the subsequent meeting (Tr. 392-394, 298-300, 334-336, 249-250). Obviously, nothing in either this encounter or the Trades Council's earlier dispatch of a committee to investigate the Carpenter's "unfair" charges "demonstrates," as the Association asserts, "that the Unions coordinated their recognition demands through the council"

[36] Ellison, the Carpenters' representative on that committee when it visited Colson in October, of course had an additional purpose, as we have shown, but this hardly suggests that each of the other union agents present—or the Council—shared that purpose. We assume that each would have desired, or hoped for, Colson "going union," but this would presumably be true as a general proposition of all unions; it cannot prove a common campaign or a principal-agent relationship.

(Assoc. Brief, p. 14). Nor does the fact that the Unions agreed, at the January 12 meeting, to take up in the Trades Council the matter of permitting Colson to complete its "church job" with its existing non-union subcontractors show that the Carpenters and Laborers, in asking recognition, were acting in "a representative capacity" — presumably, as "representatives" of the Council (Assoc. Brief, p. 14). The offer is at least as consistent with a recognition by Carpenters and Laborers that, while they could assure that they would not enforce Article I-C on the "church job," other crafts might object and/or establish pickets and thus disrupt Colson's business unless prior arrangements to the contrary were made on the initiative of the Unions seeking recognition from Colson. To seek such an arrangement is not to betray a prior Trades Council plan to organize Colson. Were the Board to have predicated a finding of "joint venture" on the Unions' common participation in the Trades Council, surely it could not have been said to have rested upon substantial evidence.

The Association's reliance on the Master Agreement also proves either too much or too little. Thus, if the fact that both Local 1089 and Local 383 were signatory to the Agreement suffices to make each responsible for the other's picketing, then the same fact suffices to hold all other unions signatory to the Agreement, a patently preposterous proposition. Since the statutory violation in question here is not the demand for recognition, or even picketing for recognition, but rather overly-extended picketing for that purpose, it seems evident that it is the *picketing* of the

two Unions that must be connected and not simply the fact, much stressed by the Association, that both were party to the Master Agreement. On the other hand, that recognition of either through the Master Agreement would have resulted in recognition of the other is not sufficient to show that the Unions were jointly engaged in seeking recognition, either in general or specifically from Colson. That Laborers Local 383 would gain "derivative benefits" (R. 5) were Colson to have signed the Agreement for Local 1089—just as would some 15 other unions—does not show that Local 1089, in seeking recognition, "[was] requesting recognition, or . . . even interested in obtaining recognition, for the Laborers" (R. 58). At the most, the Master Agreement shows a jointness of collective bargaining demands and contract terms, once there is recognition; it does not, by its own bootstraps, show a common plan to obtain recognition. Still less does the existence of the Master Agreement and the fact that the Unions, at different times, in different places, and without communication between them picketed to obtain it, show a concerted plan to obtain recognition by any and all means, legal and illegal. Commonness for one purpose is not commonness for all, and all that the record here shows as to concert of action between the Unions is that, in the Master Agreement, they have agreed upon substantive contract terms. A joint campaign to organize Colson cannot be inferred from the provisions of the Master Agreement.

If such a campaign is not shown on this record, there is plainly no basis for imputing to either Un-

ion responsibility for the other's picketing. The testimony of the Union agents who ordered the picketing shows, without contradiction, that neither informed the other that it planned to picket, sought approval by the other, sought picketing or financial assistance from the other (or, indeed, any other union), or notified the other when the picketing was terminated (R. 59, 29; Tr. 286-289, 296, 310, 400, 401-402, 351-352). Similarly, neither Union notified the Trades Council of its picketing, or sought approval or aid from the Council (*ibid.*). Accordingly, as the Trial Examiner found, "Although each Local stood to benefit by the picketing of the other and no doubt each was sympathetic to the other's design and purpose *there is little but speculation* to support a conclusion that the Locals were allied in the matter. . . . The allegation that they were 'acting in concert or participation with each other' in this respect is not supported by a preponderance of the evidence." (R. 28-29).

III. The Board's order is reasonable and proper

Having found that the Unions violated both Section 8(b)(4)(i)(ii)(A) and (B) by picketing to force upon Colson an agreement prohibited by 8(e) and to force Colson to cease doing business with subcontractors Schwartz, Riggs, and Haun, the Board ordered each Union to cease and desist from these practices. The order specifically prohibits the Unions from utilizing the unlawful means here employed to procure an 8(e) agreement from Colson "or any other employer," and from resorting to the same

means—strikes or picketing—against "any other employer" with an object to force a cessation of business with the three named subcontractors (R. 60, 61).

As we read the Unions' brief (pp. 30-31), they do not object to the first part of the order, paragraph 1.(a). In any case, the injunction is adapted to the problem presented. The Master Agreement, with its cease-doing-business clause, is just what its title implies, the Unions' standard agreement; hence it is to be anticipated that each will continue to demand its adoption by area contractors and, unless restrained, to utilize strike pressure to that end. As set forth above, the Unions and employers may lawfully execute Article I-C if both choose to do so; the order, therefore, does not nullify the clause or restrain the Unions from asking its adoption. But when another employer is unwilling to commit himself to boycott, he, like Colson, is entitled to his choice. Accordingly, the order bars only strikes or picketing aimed at exacting the clause. It is thus, we submit, appropriately and specifically tailored to the situation which calls for redress.

The second portion of the Board's restraining order is also fitted to the violation shown, that is, to preventing a repetition of coercion against neutrals to bring about the business exile of Schwartz, Riggs, and Haun. Nor need either Union find itself on the horns of a dilemma as a consequence of this paragraph. If, in fact, it has "legitimate grievances" against employers "totally unconnected with the presence of [any of the three] subcontractors," then

its strike or picketing over the grievances would not fall within the injunction. Only if the Unions continue to seek the exclusion from construction projects of these nonunion subcontractors can they have any real question as to whether or not they may lawfully picket a project on which one of the three is working.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petitions for review should be denied, and that a decree should issue enforcing the Board's order in full.

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May 1963

CERTIFICATE

The undersigned certifies that he has examined the provisions of Rules 18 and 19 of this Court, and in his opinion the tendered brief conforms to all requirements.

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In The United States Court of Appeals

FOR THE NINTH CIRCUIT

Nos. 18217 and 18293 (Consolidated)

CONSTRUTION, PRODUCTION AND MAINTENANCE LABORERS UNION, LOCAL NO. 383, AFL-CIO, AND UNITED BROTHERHOOD OF CARPENTERS AND JOINERS OF AMERICA, LOCAL NO. 1089, AFL-CIO,

Petitioners,

vs.

NATIONAL LABOR RELATIONS BOARD,

Respondent and Cross-Petitioner.

INDEPENDENT CONTRACTORS ASSOCIATION,

Petitioner,

vs.

NATIONAL LABOR RELATIONS BOARD,

Respondent.

On Petition to Set Aside in Part an Order of the National Labor Relations Board and on Cross-Petition to Enforce Same (Case No. 18217); and on Petition to Review Another Part of the Same Order (Case No. 18293)

BRIEF FOR PETITIONING UNIONS

INDEX

INDEX (Cont'd)

TABLE OF AUTHORITIES CITED

TABLE OF AUTHORITIES CITED (Cont'd)

Other Authorities

In The United States Court of Appeals

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Petitioners,

vs.

NATIONAL LABOR RELATIONS BOARD,

Respondent and Cross-Petitioner.

INDEPENDENT CONTRACTORS ASSOCIATION,

Petitioner,

vs.

NATIONAL LABOR RELATIONS BOARD,

Respondent.

JURISDICTION

Construction, Production and Maintenance Laborers Union, Local No. 383, AFL-CIO, hereafter called the Laborers Union, and the United Brotherhood and Joiners of America, Local No. 1089, AFL-CIO, hereafter called the Carpenters Union, have petitioned (R. 68-70)[1] to set aside in part an order (R. 60-62) issued against

[1] References to the Pleadings, Volume I of the Record, are designated "R." References to the Transcript of Testimony are designated "Tr." References to Exhibits are designated "Ex."

them on July 26, 1962, by the National Labor Relations Board pursuant to the provisions of the National Labor Relations Act, as amended (61 Stat. 136, 72 Stat. 945, 29 USC Sec. 151, et seq.), hereinafter called the Act. The Board's Decision and Order are recorded at 137 NLRB No. 149. The conduct upon which said Order is based occurred in Phoenix, Arizona, within this judicial circuit, and was found by the Board to be unfair labor practices affecting interstate commerce within the meaning of the Act.

The Board has responded to said petition by cross-petitioning (R. 72) for enforcement of that part of said Order which the petitioning Unions are asking to be set aside.

Independent Contractors Association has intervened (R. 74) in connection with the foregoing Petition, and has, in addition, filed its Petition (R. 79) for review of another portion of the same Board Order.

STATEMENT OF THE CASE

In connection with certain picketing done by the Carpenters Union in October, 1960, and by the Laborers Union in January, 1961, the Independent Contractors Association filed charges and amended charges with the National Labor Relations Board in January and February, 1961, against these two unions, and at one time or the other, against some 20 other unions or union councils (R. 3-10).

The Board issued its Consolidated Complaint (R. 11), but against only the Carpenters Union and the Laborers Union. In brief, the Board alleged that the picketing had been jointly conducted for more than thirty days without a petition for an election under Section 9(c) of the Act having been filed, and that, accordingly, these two unions had violated Section 8(b) (7) (c) of the Act. Further, the Board alleged that the objects of the picketing were (1) to force or require Colson & Stevens Construction Co., Inc to enter into an agreement prohibited by Section 8(e) of the Act; (2) to force or require Colson & Stevens Construction Co., Inc. to cease doing business with certain subcontractors; (3) to force or require Colson's subcontractors to recognize and bargain with

these unions, or other labor organizations; and (4) to force or require Colson to recognize or bargain with these two unions as the representatives of Colson's employees, and to force or require these employees to accept or select these Unions as their collective bargaining representative, all in violation of Section 8(b) (4) (i) (ii) (A) and (B) of the Act. (R. 11-15).

After a hearing had before a duly designated Trial Examiner of the Board in April, 1961, an Intermediate Report and Recommended Order was issued on May 23, 1961, in which it was concluded (1) that neither of the Unions had violated Section 8(b) (4) (A) and (B) of the Act, but (2) that they had separately violated Section 8(b) (7) (C) of the Act "by reason of the refusal of suppliers to cross the picket lines." (R. 25-30).

Both the General Council and the unions took exceptions to this Intermediate Report insofar as it ruled against their contentions, and as a result, the Board, by its Decision and Order, dated July 26, 1962 (R. 54-65) reversed the Trial Examiner. It concluded that since neither of the unions' picketing had exceeded a reasonable period lasting more than 30 days, neither had violated Section 8(b) (7) (C) of the Act, (R. 59). But it found the separate picketing of each union to be illegal under Section 8(b) (4) (A) and (B) of the Act, and in connection therewith, said: (R. 59-69).

> "By picketing Colson and Stevens Construction Co., Inc., with an object of forcing or requiring the said Company to enter into an agreement which is prohibited by Section 8(e), the Respondents have engaged in unfair labor practices within the meaning of Section 8(b) (4) (i) and (ii) (A) of the Act.
>
> "By picketing Colson and Stevens Construction Co., Inc., with an object of forcing or requiring the said Company to cease doing business with Schwartz Plumbing Co., Riggs Plumbing and Heating Co., and Earl H. Haun, the Respondents have engaged in unfair labor practices within the meaning of Section 8(b) (4) (i) and (ii) (B)."

As a result of the foregoing findings, the Board ordered each of the Unions (R. 60 and 61) to cease and desist from:

> "Engaging in, or inducing or encouraging employees of Colson

and Stevens Construction Co., Inc., or any other employer, to engage in a strike, or threatening, coercing or restraining Colson and Stevens Construction Co., Inc., or any other employer, by a strike or picketing, where in either case an object thereof is to force or require said employer to enter into any agreement which is prohibited by Section 8(e).

"Engaging in, or inducing or encouraging employees of Colson and Stevens Construction Co., Inc., or any other employer, to engage in a strike, or threatening, coercing or restraining Colson and Stevens Construction Co., Inc., or any other employer by a strike or picketing, where in either case an object thereof is to force or require said Employer to cease doing business with Schwartz Plumbing Co., Riggs Plumbing and Heating Co., and Earl H. Haun."

STATEMENT OF FACTS

During late 1960 and early 1961, Colson & Stevens Construction Co., Inc., was engaged in the business of general construction (Tr. 172). The Company had no collective bargaining agreements with labor unions (Tr. 177). It hired only carpenters and laborers. It subcontracted to other employers the rest of its work (Tr. 177).

On two different occasions the Carpenters Union had contacted the Company and had been told that the Company did not want its carpenters to be union, that it wanted to continue on a non-union basis (Tr. 283).

The Company, in October, 1960, had a contract for the construction of a building in Phoenix, Arizona, known as the Yellow Front Store (Tr. 188). The Carpenters Union learned about this contract (Tr. 283). Thereupon it caused a letter to be written by the District Council of Carpenters to the Phoenix Building and Construction Trades Council (Tr. 281; Exhibit 7), requesting that the Company "be placed on the official "unfair list." The Phoenix Building and Construction Trades Council is an organization composed of about 20 different crafts, involving numerous unions, in the building industry in Phoenix and vicinity (Tr. 282). Among other things, it maintains an "unfair list" (Tr. 350-351). As a matter of policy the Trades Council did not take action on the

letter from the District Council of Carpenters until a committee was appointed for an investigation of the matter (Tr. 351). Accordingly, such a committee was designated: Ellison from the Carpenters Union, and a representative from each of the brickmasons', cement finishers', plumbers', and electricians' unions (Tr. 284-285). This group met at the Yellow Front job site on October 14, 1960, and while there engaged in a conversation with Mr. Colson and Mr. Stevens (Tr. 357-358).

This conversation lasted about half an hour, (Tr. 220). The brickmason union's agent, Rosensteel, had come out to ascertain whether the company did its own brickmasonry or subcontracted it out. (Tr. 383, 384). The record is essentially silent as to the purpose and the part played, if any, by the plumbers', cement finishers', and electricians' agents.

Ellison, the agent for the Carpenters Union, wanted to talk about the company's carpenters, and this is what the conversation was mostly about. (Tr. 192, 359). Mr. Colson had had some experience with labor unions (Tr. 192) and apparently believed that Ellison desired the company to sign the Arizona Master Labor Agreement (Ex. 44)[2] with the Carpenters Union. (Tr. 193).

This Agreement was the industry-wide construction agreement covering work performed by carpenters, laborers, cement finishers, and teamsters in the state of Arizona. Numerous unions representing each of these crafts, including the Carpenters Union party hereto, were signatory. This Agreement actually is four craft agreements rolled into one, having common administrative clauses, but separate wages scales and working rules for each craft.

Actually, however, *no particular agreement was mentioned in the Yellow Front conversation. Nor were any particular contract proposals made to the company.* (Tr. 359)

The company excused its desire to continue on a non-union basis, saying that to go along with Ellison would work a hardship on the company (Tr. 191) and suggesting that the purported non-unions status of its subcontractors on the job was a stumbling

[2] See Appendix for pertinent parts of this agreement.

block. " . . . and he named the subcontractors that were doing work on the project at the time." (Tr. 359). This was an apparent allusion either to the requirement of the Arizona Master Labor Agreement that signatory employers are bound to require their subcontractors to abide by the terms of that agreement insofar as their employees perform laborers', carpenters', cement finishers,' or teamsters' work (Article I.C. of Exhibit 44), or to the generally held idea that union and non-union groups do not like to work together on the same job. However, in either event, there was no problem since all of the subcontractors named to Ellison were *union* contractors. (Tr. 359) Ellison's position was that the "carpentry work was the only problem that was at stake." (Tr. 359) And his purpose was to negotiate a contract, not necessarily the Arizona Master Labor Agreement, for the carpenters. (Tr. 368, 371) "It was just strictly carpenters," Ellison testified. (Tr. 359)

The conversation terminated with Mr. Colson's saying that he couldn't go along with Ellison. (Tr. 360)

Ellison reported back to his union. (Tr. 286) On October 19th, 1960, the Carpenters Union placed pickets at the Yellow Front jobsite, bearing signs reading: "Picketing Colson & Stevens for the purpose of organizing the carpenters on the job, Local 1089." (Tr. 288) English, another business agent, testified that the Carpenters Union had no purpose other than to organize and bargain for the company's carpenters. (Tr. 296) The picketing continued, in a peaceful manner, for 28 days. (Tr. 288) During the picketing, English attempted without success to organize some of the company's carpenters, (Tr. 328, 330, 333) and was prepared to meet and negotiate on a contract if the opportunity arose. (Tr. 295, 333) But neither side to the dispute so much as made a proposal to the other. (Tr. 347) Finally, the Carpenters Union gave up the picketin gas a lost cause. (Tr 295)

After removing its pickets on Nov. 15th, or 17th (Tr. 258), the Carpenters Union did nothing further relative to Colson & Stevens. (Tr. 299)

On the following January 10th, a survey committee of the Trades Council, after going to about 14 other jobs that day,

routinely stopped by the Yellow Front job. (Tr. 391, 397) This committee consisted of Kleiner, a painters' union agent, Cooksey, an agent for the Laborers' Union party hereto, and Gromley, from the brick masons union. (Tr 391) Kleiner spoke to Mr. Stevens and indicated that they would like to talk to him. However, Stevens suggested an office meeting, and emphasized that *he definitely wanted the carpenters' representative prsent.* It was agreed that the meeting would be held on Jan. 12th at the company's office. (Tr. 393)

Kleiner contacted English of the Carpenters to arrange his being at this meeting. (Tr. 394.) Kleiner understood that the purpose of the proposed meeting with the company of Jan. 12th was to talk about future contracts the company might have in the county and to see if the union could supply employees. (Tr. 398)

Kleiner, English, Cooksey, and a representative from the brickmasons met at the company's office on Jan. 12th. (Tr. 300) Stevens was there, then Colson came in a few minutes later. (Tr. 310) The meeting lasted for an hour and a half to two hours. (Tr. 259, 301)

Stevens and English started the conversation. (Tr. 260, 301) and, as reported by English, Stevens said, "We are ready to become signatory to the agreement," explaining that in the past they had done little jobs but were getting bigger ones and now had "room" to become signatory. (Tr. 301) This had reference to the Arizona Master Labor Agreement. Thereafter much of the conversation concerned a "breaking off" point, that is a point in time *in the future* when the subcontractor clause (Art. I.C.) in the Arizona Master Labor Agreement would be effective. (Tr. 202, 302) In this connection, the company said it had a contract on the Trinity Church job and on the Tonto and Kiva schools, and had nonunion subcontractors lined up to do part of the work. After further discussion about the company's carpenters becoming members of the union, (Tr. 205) about what the "prevailing wages" were, that is, the state-required wages to be paid on the school jobs,(Tr

203, 232) and about the carpenters' apprentice program, (Tr. 233, 303) the meeting broke up.

English handed two copies of the Arizona Master Labor Agreement to Stevens near the end of the conversation (Tr 233) when the "prevailing wage" of apprentices on the school jobs were being discussed so that the company would know the scales for the 8 apprentice classifications. (Tr 203, 304)[3] English stated that this was the agreement that the company could sign if it decided to sign. (Tr 265, 307)

The testimony is in conflict as to what the understanding was when the meeting broke up. Colson testified that English wanted to check with other local unions to see if it would be all right for the company to go on with the church job on a "split basis" of union and non-union subcontractors, (Tr 206) with English to notify the company a couple days after talking with a masonry subcontractor named Haun. (Tr 207) Stevens said the understanding was that the company was going to investigate its records to see if it had union subs whose bids were close to the non-union subs (Tr 262) and that English was to tell Stevens where the company "stood with the subs." (Tr 262) However, English and Ellison understood that Stevens had indicated that the company intended to go "all union" if and when it signed the Agreement, (Tr 308, 309, 314) and that Stevens was to look thru the company files to see if there were competitive union subs (Tr 305) and was to call English before the following Tuesday (Tr 304, 305, 364) to advise whether the company would sign the Agreement (Tr 304, 305, 364); and English would then at the request of Colson take up the matter of the non-union subcontractors with the other unions at the Trades Council meeting to see if there would be any difficulty if the company went ahead and finished the church under its current contract arrangements. (Tr 307, 375)

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[3] By Arizona statutes, contractors must pay the "prevailing wage" in construction of public buildings. The prevailing wage is defined as that contained in existing union agreements in the area. See ARS 34-322 and 34-325.

Neither the company officials nor the union agents called the other at any time after the meeting ended. (Tr 208, 269) English neither contacted the subcontractor Haun (Tr 309) nor anyone else about the company (Tr 309), including the Trades Council. From the day of the meeting until served with the unfair labor practice charges in February, the Carpenters Union had done nothing or further concerned itself with the company. (Tr 309)

About two weeks later, on Jan. 25th, the Laborers Union commenced picketing the company at the Tonto and Kiva school jobs in Scottsdale, Arizona (Tr. 207, 262, 400) The pickets carried signs reading: "Picket against Colson and Stevens. Laborers Local 383 wants to organize and bargain for laborers employed by Colson & Stevens." (Tr 267, 400) The Business Agent and Sec'y-Treasurer, Warren, testified without contradiction that the sign indicated the sole object of the picketing, that he had heard that there were laborers working on the job, (Tr 404) that the union wanted to organize and represent them, (Tr 404, 420, 421) and that he was prepared to negotiate an agreement with the company. (Tr 403, 422) There was no contact between the company and the Laborers Union during the picketing. (Tr 404) There was no evidence of anything other than a peaceful picketing. The Laborers Union removed its pickets on Feb. 20th. (Tr 401)

The pickets had been placed on the job with notification to the Trades Council or the Carpenters Union and without consulting any other union (Tr 352) and was removed without contacting any other union. (Tr 401, 402)

SPECIFICATION OF ERRORS

1. The Board erred in concluding as a matter of law (R 60) that either or both of the unions picketed Colson & Stevens with an object of forcing or requiring that company to cease doing business with Schwartz Plumbing Co., Riggs Plumbing and Heating Co., and Earl H. Haun, within the meaning of Section 8(b)(4)(B) of the Act. [29 U. S. C. 158(b)(4)] In this connection, the Board erred in the following respects:

a. In finding as a fact that each union had an object of forcing

Colson & Stevens to sign the Arizona Master Labor Agreement. (R 55)

b. In concluding as a matter of law (not identified as such) that this agreement would have compelled Colson & Stevens to cease doing business with Schwartz, Riggs, and Haun, if they did not comply with the terms of said agreement; that this would have been the necessary effect of signing; (R 55)

c. In failing to find that the subcontractor clause in the agreement was aimed at the protection of wages and conditions of the Colson and Stevens employees, and therefore a proper subject of collective bargaining.

d. In concluding as a matter of law that picketing to obtain a subcontractor clause, *lawful* under section 8(e), was, without more, unlawful under 8(b)(4)(B).

e. In failing to conclude as a matter of law that the picketing was *primary* in nature, and therefore lawful.

2. The Board erred in concluding as a matter of law (R 59) that either or both of the unions picketed Colson & Stevens with an object of forcing or requiring that company to enter into an agreement which is prohibited by Section 8(e) [29 U.S.C. 158 (e)] within the meaning of 8(B) 4(A) of the Act. [29 U.S.C. 158 (b) (4)]. The agreement referred to related to *job-site construction,* and is exempt from Section 8(e).

3. Assuming, arguendo, a violation of either or both subsections (A) and (B) of 8(b)(4) of the Act, still the scope of the order is too broad in view of the record as a whole, particularly as it relates "to any other employers". (R 60, 61)

SUMMARY OF ARGUMENT

In finding each of the unions guilty of violating subsections (A) and (B) of 8(b)(4) of the Act, the Board based its decision upon conclusions that the picketing was to force the employer to sign an agreement which *by its terms* would require the employer to stop doing business with certain subcontractors.

There was no substantial evidence to support a finding, in the first place, that the signing of the argeement was an object of the

picketing. Second, the necessary legal effect of the agreement, had it been signed by the employer, was not to force the employer to "cease" doing business with the subcontractors. Third, assuming the picketing to have been to secure the signing of the agreement, it was *primary* in nature, as opposed to secondary picketing, since the agreement was a proper subject of collective bargaining. And fourth, regardless of the foregoing, the agreement was *lawful* under the construction industry proviso to section 8(e) of the Act, and therefore picketing to *obtain* its execution was not prohibited by either subsections (A) or (B) of the Act.

It is further argued, in the *alternative,* that the Board's Order is too broad in scope insofar as it relates to employers other than the one picketed, since no proclivity for unlawful conduct was shown.

ARGUMENT

The Board has held each of the unions guilty of violating subsections (A) and (B) of 8(b)(4) of the Act. [29 U.S.C. 158 (b)(4)] In pertinent part, these two subsections prohibit picketing where *an object* is:

> "(A) forcing or requiring any employer or self-employed person . . . to enter into any agreement which is prohibited by Section (8)(e);"
>
> "(B) forcing or requiring any person . . . to cease doing business with any other person . . .: Provided, that nothing contained in this clause (B) shall be construed to make unlawful where not otherwise unlawful, any primary strike or primary picketing;"

Section 8(e), [29 U.S.C. 158(e)] referred to in subsection (A) above, generally makes it unlawful for a labor organization to enter into so-called hot cargo agreements and other agreements which require an employer "to cease doing business with any other person", but makes the following proviso:

> "Provided, that nothing in this subsection (e) shall apply to an agreement between a labor organization and an employer in the construction industry relating to the contracting or subcontracting of work to be done at the site of the construction, . . ."

In finding each of the unions guilty of subsections (A) and (B)

of 8(b)(4), the Board has followed the theory of the case announced during the trial by General Counsel. (Tr 352,3) The theory was that each of the unions had picketed with an object of forcing Colson & Stevens to sign the Arizona Master Labor Agreement, and that this Agreement *by its terms* would compel the company to cease doing business with its subcontractors unless they complied with the Agreement's provisions. Therefore, it was reasoned, the picketing to obtain the agreement was picketing for a prohibited object.

No contention was made by General Counsel, or held by the Board, that the Agreement was itself illegal or prohibited by Section 8(e), or that either of the unions had a dispute with any of the named subcontractors, or that the picketing was anything but peaceful and in accordance with the *Moore-Drydock* standards for common-situs picketing.

The several issues raised by this appeal relating to the alleged subsections (A) and (B) violations will be argued first.

The scope of the Board order will be argued last.

I

As a matter of fact, neither union picketed with an immediate or direct object of forcing Colson and Stevens to sign the Arizona Master Labor Agreement. The picketing was for organizational and recognitional purposes only.

The key finding made by the Board was that each of the unions picketed to force Colson & Stevens to execute the Arizona Master Labor Agreement. (R 55; Exhibit 44) In view of the protection afforded to primary disputes under Section 13 of the Act,[4] the necessary implication is that the Board found the signing of the Agreement, without modification, to be a *direct* or *immediate* object of the picketing. *NLRB v. Bangor Building Trades Council,*

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[4] Section 13 reads: "Nothing in this Act, except as specifically provided for herein, shall be construed so as either to interfere with or impede or diminish in any way the right to strike, or to affect the limitations or qualifications on that right."

278 F.2d 287; *NLRB v. Denver Building and Construction Trades Council,* (1951) 341 U.S. 675; *NLRB v. International Rice Milling Co.* (1951) 341 U.S. 665.

It follows that if such a finding of *fact* is not supported by substantial evidence, then that ends the case and the Decision must be reversed as to the 8(b)(4) violations.

The Carpenters Union picketed Colson & Stevens for 28 or 30 days, beginning October 19th. (Tr 287) Before that, there had been only one contact between this union and the company which could be remotely related to the picketing. That occurred on October 14th, when the union's agent, Ellison, talked with Colson & Stevens at the Yellow Front jobsite about the *carpenters* and about becoming a union contractor. (Tr 359)

The October 14th meeting never reached the level of negotiations, actually. *Nothing* was said about the Arizona Master Labor Agreement. (Tr 359) Certainly there was *no issue raised as to the subcontractor clause,* however, it may be interpreted, since as Ellison understood the matter, all of Colson's subcontractors were *union* contractors. (Tr 313, 359)

Some attempts had been made before the picketing began to organize the company's carpenters, and the same thing occurred after the picketing. (Tr 333, 371) In this respect, the picket sign stated that the Carpenters Union wanted to *organize* and *represent* the company's *carpenters.* (Tr 288) This, it was testified without contradiction, was the *sole* purpose of the picketing. (Tr 296) Had the company consented to negotiate, the Carpenters Union would have bargained for *an* agreement, not necessarily the Arizona Master Labor Agreement. (Tr 295, 371)

The Carpenters Union quit its picketing in mid-November and simply forgot about the matter (Tr 295) until in the *following January* when its agents were *invited by Colson & Stevens* to attend a meeting apparently to discuss the company's becoming a union contractor. (Tr 295, 300, 393) This was the *first* time that the Arizona Master Labor Agreement was mentioned—*long after the Carpenters Union had finished its picketing.*

So much for the Carpenters Union.

As for the Laborers Union, it began picketing in late January. It, too, indicated a desire to organize Colson's employees, that is, its *laborers.* (Tr 400) *There was no other object.* (Tr 400, 420, 421) The only possible tie-in between the picketing and the Arizona Master Labor Agreement—a very fragile one, too—is that one of the Laborers Union's agents attended the January meeting when Colson & Stevens discussed signing the agreement. (Tr 300) However, the Laborers Union stood ready to negotiate, and not necessarily for the Arizona Master Labor Agreement. (Tr 404)

After picketing for less than 30 days, the picket was removed (Tr 400, 401)

So much for the Laborers Union.

A further implication of the Board's findings is that each of these unions, in picketing, was telling Colson & Stevens to sign the Agreement on a take-it-or-leave-it basis, or else the company would be picketed until it did sign. The record simply will not support such a finding. Even if it can be inferred that each union picketed to force the company to *negotiate,* or to negotiate and sign *some kind of an agreement,* this does not necessarily mean that the Arizona Master Labor Agreement, intact with its subcontractor clause, was required by the picketing.

It is therefore respectfully submitted that the Decision should be reversed, since on this crucial finding of *fact,* there is no substantial evidence in support thereof.

II

Had Colson & Stevens signed the Arizona Master Labor Agreement, it would not, by its terms, have compelled that company to "cease doing business" with subcontractors Schwartz, Riggs and Haun. Therefore, the signing of the Agreement was not a proscribed object of the picketing within the meaning of subsection (B) of 8(b)(4).

The Board's conclusion that this Agreement would have compelled Colson & Stevens to "cease doing business" with Schwartz, Riggs, and Haun, is couched in the statutory language of subsec-

tion (B). This phrase is identical to that used in section 8(e) which deals expressly with these kinds of agreements. To *cease* is not the same as to *refrain* from doing business. The former refers to *existing* contractual relationships. The latter refers to *in futuro* relationships. *Hoffman v. Teamsters, Joint Council No. 38* (N. Dist. Calif.; 1962) —F. Supp.—, 45 L.C. ¶ 17.803 Also, see "A Critical Analysis" in *The Georgetown Law Journal,* Vol. 48, at p. 355. The line of cases permitting restrictions on subcontracting, hereinafter cited in detail in Argument III, is consistent with this distinction, although based on another ground.

This is an important distinction in this case because *there were no existing contractual relationships* between Colson & Stevens and the subcontractors named, *which would have been affected by the terms* of the Agreement.

First, it should be noted that when the Carpenters Union *began* picketing, only Schwartz had an *existing* contract. The rest of the subcontractors were union, and this would exclude Haun and Riggs. (Tr 53, 130, 200, 313) Haun's subcontract was dated Oct. 21, 1960. (Tr 130) When the Laborers Union began picketing in January, of the three only Riggs had an *existing* contract. (Tr 53) Thus, if Colson & Stevens had signed the Agreement with the Carpenters Union in October at or before the picketing began, it couldn't have caused the company to "cease doing business" with Haun or Riggs. Likewise, as to Schwartz and Haun when the Laborers Union began picketing.

Secondly, as to any subcontracts then in existence at the time either of the unions picketed, the signing of the Agreement would *not* have affected them either. Quite obviously, as a matter of simple contract law, *the extent of the rights and liabilities of the subcontractors was already fixed by such existing subcontracts,* and none of the subcontractors legally could have been compelled by Colson & Stevens to change them to accommodate the provisions of the Arizona Master Labor Agreement.[5]

[5] Many of the basic parts of the Agreement are reprinted in the Appendix. The subcontractor clause (Article I. c) binds the general contractor: "Provisions shall be made in such subcontract for the observances by said subcontractor of the terms of this agreement. . . ."

It may be that Colson & Stevens would have had to pay damages pursuant to grievance procedures in the event either of the existing subcontractors failed to pay wages, etc., at the level called for in the Arizona Master Labor Agreement. Of course, this is merely *speculative,* since for no other reason there was no showing in the record that these subcontractors were not maintaining a level of wages and conditions as high as that called for in the Agreement. As to Riggs on the school jobs, the presumption would be that he was so paying, since these jobs required, pursuant to state law, the payment of "prevailing wages." The prevailing wages on the jobs are determined by the terms of the various AFL-CIO labor agreements in the area. A.R.S. 34-322 and 325 (Tr. 203).

Thus, the signing of the agreement could have affected these subcontractors *in futuro* only, when Colson & Stevens, in accordance with the Agreement, would quite probably, but not necessarily, have required them to observe the standards established by the Agreement in any *subsequent* subcontracts entered into with them. But, this would not constitute a *ceasing* to do business within the meaning of the Act. Therefore, the signing of the Agreement was not a proscribed object of picketing.

This distinction between *existing* and *in futuro* relationships is especially put into issue in this case since the General Counsel contended, and the Trial Examiner and the Board have held, that the object of the picketing was to *obtain* the Agreement. General Counsel contended and the Board has held that the Agreement "by its very terms" (R 55) also made an object of the picketing the forcing of Colson & Stevens to cease doing business with these subcontractors. The Trial Examiner disagreed with such legal conclusions, and properly so. *At no time* has it been found that either union picketed *with an intent to continue doing so* until the *subcontractors* came to terms or were forced off the job. To the contrary, the Trial Examiner expressly found (R 28), and was not reversed by the Board, that:

> "Neither Local asked Colson immediately to terminate his subcontracts and neither made any demands on the subcontractors. All concerned expected changes in these relationships once the

> Master agreement was signed. But it may not be assumed that the Locals or either of them would have sought to enforce the subcontracting clause of the Master agreement by unlawful means. *The signing was the objective and enforcement was left to the future....*" (emphasis added)

The point is emphasized that the Board predicated its conclusion that the picketing was illegal, as having a prohibited object thereof, *solely* on the *legal effect* of *the terms* of the Agreement. It follows, of course, that if the Board erred in this respect then its Decision must be reversed as to the subsection (B) violation.

One further reason why the *terms* of the Agreement would not have affected these named subcontractors, and this regardless of their status as existing or future contractors: None of them employed persons working in the *classifications covered* by the Arizona Master Labor Agreement. Schwartz and Riggs were plumbers. Haun was a brickmason. The inference is that these crafts have separate collective bargaining agreements. (Tr 382)

The Arizona Master Labor Agreement (Ex. 44) was negotiated originally by several contractor associations and the several *carpenter, laborer, cement mason,* and *teamster unions,* to cover the wages, hours, etc., of just those *particular classifications* of employees. *At no place in the Agreement are there provisions relating to plumbers and brick masons.* Thus, unless these named subcontractors were employing carpenters, laborers, cement masons, or teamsters — and there is no substantial evidence on this — there would have been absolutely no effect upon these subcontractors "by the very terms" of the Agreement.

For the reasons stated, it is respectfully submitted that the Board erred in concluding that the picketing had an illegal object of forcing Colson & Stevens to *cease doing business* with the three named subcontractors within the meaning of subsection (B) of 8 (b) (4).

III

Assuming arguendo that the signing of the Agreement was an object of the picketing and that the terms of the Agreement would have affected the various subcontractors, nonetheless the picketing

was primary in nature and therefore not unlawful under section (B) of 8 (b) (4) since the subcontractor clause was a mandatory subject of collective bargaining.

Colson & Stevens was engaged in the construction industry. At the time of the picketing it was employing carpenters and laborers but subcontracting all other work requiring the other crafts. (Tr. 177)

The general nature of the construction industry is such that a general contractor will be working one week at one place, with numerous employees in numerous classifications, but will be working the next week at an entirely different place, with an entirely different group of employees. Depending upon the job involved, the general contractor will use either a few or many employees, and either a few or many employee classifications. Depending on the job it will subcontract extensively, or not at all. Work is intermittent and contractors customarily find themselves between jobs with no employees at all on the payroll.

Workers following this industry are paid for the hours worked only and must, of necessity, shift from job to job, from contractor to contractor, in order to maintain a substantial frequency of employment.

In short, as to contractors in this business, there is no certainty from week to week what the collective bargaining unit of employees will be.

In these circumstances where the contractor can either subcontract a lot or a little, *at will,* it becomes necessary that the contractor be induced to agree to condition his subcontracting in such a manner as will protect the jobs and work standards of the unionized workers employed by him, and in a manner as will obviate the effect of any subcontracting done for the mere sake of dodging the collective bargaining agreement. On the other hand, because of the economics of the industry, the contractor is left free to subcontract when bona-fide business reasons dictate such a move. These would have been the effects of the Arizona Master Labor Agreement had Colson & Stevens signed it.

The subcontractor clause contained in said Agreement, which

according to the Board's theory tainted the picketing with illegality, reads as follows:

> "C. That if the Contractors, parties hereto shall subcontract construction work as defined hereafter in Article III of this Agreement, the terms of said Agreement shall extend to and bind such construction subcontract work, and provisions shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement. A subcontractor is defined as any person, firm or corporation who agrees under contract with the general contractor or his subcontractor to perform on the job site any part or portion of the construction work covered by the prime contract . . . "

This clause says to the signatory contractor that it is responsible to see to it that the wage and working standards set out in the Agreement shall be complied with, should it subcontract any work to be performed *by the employees covered by the Agreement.* This would have discouraged Colson & Stevens from, for example, subcontracting all carpentry work on its next job after the Yellow Front. At the same time, it would not have prohibited such subcontracting in the event some bona fide business reason indicated the desirability to do so.

The placing of restrictions upon subcontracting has long been recognized as a matter of legitimate concern on the part of organized labor. In *Ohio Valley Carpenters District Council,* etc., 136 N.L.R.B. No. 89 (1962), the Board stated the rule thusly:

> ". . . it has long been recognized that restrictions on subcontracting work out to another employer, or on(e) otherwise having done elsewhere work *usually performed by employees in a bargaining unit,* is a mandatory subject of collective bargaining and a proper matter for contract inclusion. See, Timkin Roller Bearing Co., 70 NLRB 500, 518; W. L. Rives Co., 125 NLRB 772, 782; Local 24, Teamsters v. Oliver, 358 U. S. 283, 294-5 (36 LC ¶ 65, 161). *Contractual restrictions of this character undoubtedly impinge upon an employer's freedom to engage in business with others."* (Emphasis supplied.)

Further examples of this kind of collective bargaining may be found in *Railroad Telegraphers* v. *Chicago & Northwestern Ry. Co.,* 362 U. S. 330, 45 LRRM 3,104. The Supreme Court held that an employer railroad was obligated to bargain concerning its

decision to abandon a number of stations and to discharge the station agents. In *Local 24, Teamsters* v. *Oliver* (1959) 358 U. S. 283, 43 LRRM 2,374, an agreement regulating the minimum rental and other terms of leases between the carrier employer and his "employees" who owned and operated their own trucks in the service of the employer, was held to be "a direct frontal attack upon a problem thought to threaten the maintenance of the basic wage structure established by the collective bargaining agreement," and therefore was a proper subject of collective bargaining. The court noted that the federal labor laws were calculated to promote collective bargaining, "to encourage the employer and the representative of the employees to establish, through collective negotiation, their own charter for the ordering of industrial relations, and thereby to minimize industrial strife." It also said: "Within the area in which a collective bargaining was required, *Congress was not concerned with the substantive terms upon which the parties agreed.*" (Emphasis supplied.)

In *Deaton Truck Line* v. *Local 612, Teamsters* (CA-5; 11/1962),—F.2d—; 51 LRRM 2552, it was held that a union had a legitimate interest in protecting its area wage standards by making them applicable to lessor-drivers who were not employees as well as to employee-drivers. The case there involved section 301 of the Act which permits suits for breach of collective bargaining agreements to be brought in federal courts. In referring to the *Oliver* case, supra, the Circuit Court said:

> "The Supreme Court has heretofore taken the position that it is not necessary to determine whether owner-operators are 'employees' protected by the Act, since the establishment of minimum rental to them was integral to the establishment of a stable wage structure for clearly covered employee-drivers. Teamsters Union v. Oliver, 1959, 358 U. S. 283, 294-295, 43 LRRM 2374; United States v. Drum, 1962, 368 U. S. 370, 382, n. 26. It is true that in Oliver, approved in Drum, the bargaining unit included an overwhelming majority of concededly employed drivers, while in the present case there are very few admitted employees, and an overwhelming majority of lessor-drivers. However, the Union points out, soundly we think, that it has a legitimate interest in protecting its area wage standards.

> See In re Local Union No. 741, etc. (Keith Riggs Plumbing, etc.), 1962, 137 NLRB No. 121, 50 LRRM 1313 at 1314..."

In *Local Union No. 741, etc. (Keith Riggs Plumbing, etc.)* cited by *Deaton,* supra, the Plumbers Union had picketed Riggs on certain building projects in Tucson, Arizona, not for organizational or recognitional purposes, but simply to advertise and put pressure on Riggs to force him to cease and desist from paying wages and benefits below the area standards. The Board held this to be *protected* activity and not unlawful, even though as a result of the picketing, employees of other employers refused to cross the established picket line. The Board noted:

> "...Indeed the importance of maintaining area standards as a matter of public as well as union interest was long ago endorsed by Congress by its enactment of the Davis-Bacon Act (40 U.S. Code, Sec. 276a et seq.) . . ."

In *Town and Country Manufacturing Co.,* 136 N.L.R.B. No. 111, 49 LRRM 1918, the Board held that a company was required to collectively bargaining before subcontracting our work in the bargaining unit even though the company's motives might have been purely economic.

For further variation of the basic rule, see *Local 19, Longshoremen,* 137 NLRB No. 13.

In the instant case, the effect of the subcontractor clause on Colson & Stevens, had it signed the Agreement, would have been to protect to some degree the jobs and the working standards established under the Arizona Master Labor Agreement for its carpenters and laborers. For this reason, and pursuant to the authorities hereinabove stated, the subcontractor clause was a mandatory subject of collective bargaining. Thus picketing to obtain such a clause was *primary* conduct permissible under Sections 7 and 13[6] of the Act, and was *not* unlawful within the meaning of (B) of 8(b)(4). Accordingly, it is respectfully submitted that the Board's Decision and Order should be reversed to the extent that it finds a violation of subsection (B).

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[6] These sections permit picketing for collective bargaining purposes, among others, except where such conduct is specifically prohibited. 29 U.S.C. 157,163.

IV

Assuming, arguendo, that the picketing was to obtain the signing of the Arizona Master Labor Agreement, nonetheless such conduct was primary in nature and not in violation of either subsection (A) or (B) of 8(b)(4), since the Agreement was lawful, and expressly so declared by the construction industry proviso to section 8(e).

The prime basis for finding the 8(b)(4) violations in this case is the Board's *per se* proposition that "a strike or picketing to obtain such agreements (referring to the subcontractor clause in the Arizona Master Labor Agreement) would . . . be, without more, unlawful under section 8(b)(4)" prior to the 1959 amendments. (R.55) This, of course, was not the law prior to 1959, and even if it were, the amendments in 1959 made *lawful* such conduct insofar as the *construction* industry is concerned.

An analysis of the statutes involved will demonstrate that neither of the unions violated the prohibitions therein contained.

Subsection (A) of 8(b)(4) makes picketing unlawful where an object is:

> "(A) forcing . . . any employer . . . to *enter* into any agreement which is prohibited by section 8(e);" (emphasis added)

Section 8(e), in material part, reads:

> "(e) It shall be an unfair labor practice by any labor organization and any employer to *enter* into any contract . . . whereby such employer ceases . . . or agrees . . . to cease doing business with any other person, and any contract or agreement *entered* into heretofore or hereafter containing such an agreement shall be to such extent unenforceable and void: *Provided, that nothing in this subsection (e) shall apply to an agreement between a labor organization and an employer in the construction industry relating to the contracting or subcontracting of work to be done at the site of the construction. . . .*" (Emphasis added)

Subject to the construction and garment industries' exemptions, the purpose of these two statutes was to outlaw hot-cargo and boycott agreements generally, and to make it an unfair labor practice for a union to strike or picket to force an employer to enter into

an agreement of that sort. *NLRB v. Lithographers, Local 17* (CA-9; 1962) 309 F.2d 31; 45 LC ¶ 17,817.

But, the Trial Examiner found (R 28) that "Colson is engaged in the *construction* industry and the contract sought would have application *only to work done at the construction site.*" (Emphasis added) The Board confirmed this finding. (R 54) *Thus, the Arizona Master Labor Agreement falls precisely within the exception to 8(e).* In short, it was "not prohibited by section 8(e)" within the meaning of subsection (A).

By the simplest of logic, therefore, picketing to force Colson & Stevens to enter into the Agreement could not be said to be in violation of subsection (A) of 8(b)(4).

Notwithstanding the *plain and unambiguous* language used in these two statutes, the Board maintains that statutory harmony and the "general purposes of Congress and the previously applicable law" require the courts to blind themselves to the obvious and to find, somehow, that picketing to obtain this agreement, although *not* prohibited by section 8(e), was violative of subsection *(A)* of 8(b)(4).

But the Board points to *no ambiguity* in either subsection (A) or in the proviso to 8(e). Instead, it suggests that the implications of *Sand Door (Local 1976, United Brotherhood of Carpenters, etc. v. NLRB,* 357 U.S. 93, 98), and the legislative history of the Landrum-Griffin Act call for such a conclusion. This approach to statutory construction is improper. *Ex Parte Collett,* 337 U.S. 55; *Gemsco, Inc.* v. *Walling,* 324 U.S. 244; *Packard Motor Co.* v. *NLRB,* 330 U.S. 485; *Unexcelled Chemical Co. Corp.* v. *U.S.,* 345 U.S. 59; *Servette, Inc.* v. *NLRB* (CA-9; 1962) 310 F2d 659, 46 LC ¶ 17,944.

The Board made the same contentions in *LeBus, etc.* v. *Local 60, United Asso., etc.,* 193 F.Supp. 392 42 LC ¶ 16,930. The Court had this to say about the Board's position:

> "There is no merit in the NLRB's argument that the quoted proviso of subsection (e) merely sanctions *voluntarily entering into* a 'hot cargo' agreement in the construction industry but does not lift the ban on coercive measures designed to *force* such

a stipulation from an employer. Whatever the wisdom of the policy, the clear text of § 8(b)(4)(A) denies the union its traditional weapons only when it would use them to secure an *illegal* agreement, and neither § 8(e), which 'shall not apply' to such an agreement, nor any other provision, condemns the so-called 'subcontractor clause' in bargaining contracts. As the NLRB itself emphasizes, the Conference Report with regard to the proviso to § 8(e) dealing with such agreements says it was 'not intended * * * (to) change the existing law with respect to judicial enforcement of these contracts or *with respect to the legality of a strike to obtain such a contract,*' and, while either implication might be read in the language, the fact is that striking to obtain a subcontractor agreement was not illegal when the Taft-Hartley Act was amended in 1959. *Carpenters' Union v. Labor Board (Sand Door),* 357 U.S. 93 (35 LC ¶ 71,599), had merely held that such an agreement could not be 'enforced' through a prohibited secondary boycott, but it did not condemn other lawful activity directed to persuading the employer to enter into that type of stipulation. Nothing in the original Taft-Hartley law, or in its legislative history, indicates an intent to ban such activity and there is no ground for holding that conduct illegal. It follows that the charge under § 8(b)(4)(A) is without merit."

Likewise, in *Cuneo v. Carpenters, Essex County & Vicinity,* 207 F.Supp. 932, 45 LC ¶ 17,826, the court, in dealing with facts quite parallel to those in the instant case, said:

". . . I respectfully reject as a precedent here the Board's conclusion in *Colson & Stevens* that the agreement in question was 'prohibited by section 8(e)' of the Act for the simple reason that the agreement presently in question is *expressly* excepted from the prohibition of that section by the proviso thereof . . ."

It is respectfully submitted that the Board erred in concluding that either of the unions violated subsection (A) of 8(b)(4) in picketing to obtain an agreement *expressly exempt* from the prohibitions of section 8(e). Accordingly, the Board's Decision should be reversed in this respect.

But did the unions violate what is now subsection *(B)* of 8(b)(4) by picketing to *obtain* the Arizona Master Labor Agreement? It is respectfully submitted that they did not.

Prior to the 1959 amendments, subsection (A) of 8(b)(4) was the so-called secondary boycott statute. In material part, (and subject to much interpretation) it prohibited picketing where an immediate or direct object thereof was:

> "(A) forcing or requiring any employer . . . to cease doing business with any other person;"

This subsection was redesignated as subsection (B) as a result of the Landrum-Griffin amendments. Also, a proviso was added. In material part, (B) prohibits picketing where an immediate or direct object thereof is:

> "(B) forcing or requiring any person . . . to cease doing business with any other person . . . : Provided, that nothing contained in this clause (B) shall be construed to make unlawful where not otherwise unlawful, any primary strike or primary picketing;"

The formal explanation for the effect of this *proviso* was given in the House Report, H. R. Rep. No. 1147, 86th Cong., 1st Sess. 38 (1959) I. Legis Hist LRMDA 942 as follows:

> ". . . The purpose of this provision is to make it clear that the changes in Section 8(b)(4) do not overrule or qualify the present rules of law permitting picketing at the site of a primary labor dispute. *This provision does not eliminate, restrict, or modify the limitations on picketing at the site of a primary labor dispute that are in existing law.*" (emphasis added)

Quite clearly, it becomes important in the instant case to ascertain how this subsection was *interpreted* prior to the 1959 amendments, since the Board predicates its Decision upon "the proposition that a strike or picketing to obtain such agreements (as the Arizona Master Labor Agreement) . . . (was), without more, unlawful under Section 8(b) (4) (A) prior to the 1959 amendments." (R 55)

What about the Board's proposition? One thing is certain—it is *novel.* This in itself hardly recommends it, since the instant case involves a fact situation that must have been repeated thousands of times since the Taft-Hartley was passed in 1947. The cases[7]

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[7] *Texas Industries, Inc.,* 234 F2d 296 (CA-5) *NLRB v. Bangor Bldg. Trades Council,* 278 F.2d 287 (CA-1); *Bricklayers, etc.,* 125 NLRB 1179.

cited by the Board in its Decision (R 55) are clearly distinguishable on their *facts* and in some instances on the particular statutes involved. Nor is accuracy of such a proposition "implicit" in the legal analysis of the *Sand Door* opinion. *(Local 1976, United Brotherhood of Carpenters v. Labor Board, supra.)*

As for *Sand Door,* it held that a union could not engage in picking of a *neutral* employer with a prohibited object under what is now (B), and then excuse such conduct by saying it was merely enforcing its hot cargo agreement with the neutral employer. But the court made it plain that a hot cargo agreement was *legal, that unions could properly negotiate for such agreements,* that the existence of such an agreement was *not prima facie* evidence of illegal inducement, and even went so far as to say:

> ". . . . It does not necessarily follow from the fact that the unions cannot invoke the contractual provision in the manner in which they sought to do so in the present cases that it may not, in some totally different context not now before the Court, still have legal radiations between the parties."

In *Le Bus, Regional Director, etc. v. Local 60, United Assn. of Journeymen, etc., supra,* the court held that

> ". . . . the fact is that striking to obtain a subcontractor agreement was not illegal when the Taft-Hartley Act was amended in 1959. *Carpenters' Union v. Labor Board (Sand Door)* 357 U.S. 93, had merely held that such an agreement could not be 'enforced' through a prohibited secondary boycott, but it did not condemn other lawful activity directed to persuading the employer to enter into that type of stipulation. Nothing in the original Taft-Hartley Act, or in its legislative history, indicates an intent to ban such activity . . . ."

In *Cueno v. Carpenters, etc.,* supra, the court said:

> "The *Sand Door* case, upon careful perusal, does not . . . disclose support for the contention that the presently pending strike constitutes an unfair labor practice under the Act, either before or since the 1959 amendment . . . . *Sand Door* did not hold that members of a labor organization, in negotiating a collective bargaining agreement with their employers, might not employ a strike as a means of forcing the employers to include in the agreements provision that members of a Union

would not be forced to work upon construction projects alongside of non-union employees of subcontractors thereon . . . ."

The Board's position in the instant case is somewhat akin to that which it recently stated to this court in *NLRB* v. *Lithographers, Local 17,* (CA-9; 1962), supra. There the Board urged that a "chain shop" clause "standing by itself" was unlawful because it would permit a kind of strike unlawful under 8(b)(4). This court noted, however, that the chain shop clause had nothing to do with *strikes or other coercive action* "standing by itself," and said:

"It follows that if the chain shop clause is unlawful it must be because some provision of the Act other than 8(b)(4)(A) and (B) make it so . . . ."

Likewise, the subcontractor clause in the instant case has nothing to do with strikes or other coercive action in and of itself. Likewise, it would involve a kind of strike unlawful under 8(b)(4) *if* either of the unions engage in that kind of conduct to *enforce* it. And, likewise, it must follow that *if the clause is unlawful, it must be because some provision of the Act other than 8(b)(4)(A) or (B) make it so.*

Further, this court in *Lithographers,* supra, by clarifying the Board's Order there enforced, declared that "insistence" upon the chain shop clause would not violate the Order as affirmed. Noteworthy is the fact that the court recognized that if coercion were used under certain circumstances to *enforce* the chain shop clause, this would be unlawful. The thrust of this ruling is that picketing to *obtain* a legally phrased clause is *not* subject to the ban of subsection (B) of 8(b)(4), even though the same conduct to *enforce* it might involve such a violation.

Not only have the few cases dealing specifically with this kind of situation ruled contrary to the Board's self-serving statements as to the "law" before 1959, but, also it seems that the Board is urging a position completely at odds with the long-settled rullings regarding what is *secondary* and what is *primary* picketing. In *NLRB v. International Rice Milling Co.,* supra, it was held that 8(b)(4) did not seek to interfere with the ordinary strike. And *that* is all that was involved in the instant case.

The Supreme Court in *Sand Door,* supra, noted that 8(b)(4) does not prohibit *all* secondary boycotts, saying:

". . . It aimed to restrict the area of industrial conflict insofar as this could be achieved by prohibiting the most obvious, widespread, and, as Congress evidently judged, dangerous practice of unions to widen that conflict: the coercion of *neutral* employers, themselves not concerned with a primary labor dispute, through the inducement of their employees to engage in strikes . . . ." (Emphasis added)

Also, see *Local 761, Inter. U of E., R & M. Wkrs, v. N.L.R.B.,* 366 U.S. 667.

This is still the *aim* of 8(b) (4) (B). Colson & Stevens was certainly not a *neutral,* and the picketing at *that company's premises* certainly was not a *widening* of a conflict which the unions had with somebody else. In fact it was acknowledged by General Counsel (Tr 352) that neither of the unions had a dispute with any of the named subcontractors. At least, he objected to testimony on this point as being *irrelevant.*

The *only* legislative history having any bearing on this matter is that found in the 1959 amendments. There, *Sand Door* was assumed to have held that picketing to *enforce* hot cargo agreements was illegal. Sen. Kennedy said:

"The first proviso under new section 8(e) of the National Labor Relations Act is to preserve the present state of the law with respect to picketing at the site of a construction project and with respect to the validity of agrements relating to the contracting of work to be done at the site of a construction project.

This proviso affects only section 8(e) and therefore leaves unaffected the law developed under section 8(b)(4). The *Denver Building Trades* (341 U.S. 675) and the *Moore Drydock* (92 N.L.R.B. 547) cases would remain in force.

Agreements by which a contractor in the construction industry promises not to subcontract work on a construction site to a nonunion contractor appear to be legal today. They will not be unlawful under section 8(e). The proviso is also applicable to all other agreements involving undertakings not to do work on a construction project site with other contractors or subcontractors regardless of the precise relation between them. Since the proviso does not relate to section 8(b)(4), strikes and

> picketing to enforce the contracts excepted by the proviso will continue to be illegal under section 8(b)(4) whenever the *Sand Door* case (357 U.S. 93) is applicable.
>
> It is not intended to change the law with respect to the judicial enforcement of these contracts, or with respect to the legality of a strike to obtain such a contract.
>
> It should be particularly noted that the proviso relates only to the contracting or subcontracting of work to be done at the site of the construction. The proviso does not cover boycotts of goods manufactured in an industrial plant for installation at the jobsite, or suppliers who do not work at the jobsite." H.R. Rep. No. 1147 on S. 1555, 105 Cong. Rec. 16415, II Legis. Hist. of LMRDA 1433.

Not only by these expressions which are consistent with *LeBus,* supra, *Cuneo,* supra, & *Lithographers,* supra, *but also by the statutes actually passed,* did Congress reveal *its understanding* of the law as it existed before the amendments. It *voided* by 8(e) all hot cargo agreements, leaving only certain construction site and garment industry agreements excepted, and it made it illegal under 8(b)(4)(A) to *force* an employer to *enter* into the *voided* agreements. It seems obvious that Congress believed that what is now subsection *(B)* of 8(b)(4) would *not* prohibit strikes and picketing to force employers to *enter* into the kinds of agreements declared to be void. *Therefore, to make it unlawful to picket to obtain these kind of agreements Congress adopted an express statute to that affect, namely subsection (A).* The Board's contention that picketing to obtain such an agreement, "without more," is unlawful under (B) "by reason of the law prior to the 1959 amendments," imputes to Congress not only a misunderstanding as to what the law then was, but also the doing of an absolutely needless thing, even a redundant and confusing thing, in cluttering the statutes with *(A).* Such a presumption cannot properly be indulged in, of course.

There has been no shortage of scholarly and contradictory comment in the various law journals concerning the meanings to be given to the scissors-and-paste job done to the law by the 1959 amendments. But the most penetrating and succinct observation

yet discovered by this writer regarding the Congressional intent toward the construction industry and the inter-play of subsections (A) and (B) was made by the Trial Examiner in this very case when he said: (R 28)

> ". . . It would be indeed an anomaly and a pointless hoax for Congress to permit otherwise lawful picketing for a "subcontractors clause" in the construction industry in Section 8(b)(4)(A) as coupled with Section 8(e) and then to forbid it under Section 8(b)(4)(B). I find it did not do so . . . ."

It is respectfully submitted that nothing in this case calls for the "expansive reading" given (A) & (B) by the Board in its Decision. Such an interpretive approach is not appropriate or allowable. *NLRB v. Teamsters, Local* 639, 362 U.S. 274, 39 LC ¶66,351.

The Board's finding that the unions' picketing violated (B) of 8(b)(4) should be reversed.

V.

Assuming, arguendo, a violation of either subsection (A) or (B), or both, by either or both of the unions, still the Order is too broad in scope, particularly as it relates to "any other employer."

The Board's Order (R 60, 61) is the same as to each union. It orders each of them to cease and desist from certain conduct relative to Colson & Stevens "or any other employer."

The evidence will not support a proclivity for unlawful action by either of the unions. Nor was there a finding relating to the likelihood of similar violations. Yet the Order places each of the unions in a dilemma in respect to employers against whom they have legitimate grievances if either Schwartz, Riggs, or Haun happens to be a subcontractor on the job, even though such grievance may be totally unconnected with the presence of these subcontractors. For these reasons, it is respectfully submitted that the Order should be modified by striking the words, "or any other employer" wherever they appear in the Order. *NLRB* v. *United Ass'n of Journeymen, et al.,* (CA-9; 1962) 300 F2d 649; 44 LC Para 17,512; *NLRB* v. *International Longshoremen's and Ware-*

housemen's Union, Local 10, et al., 283 F2d 558 (CA-9; 1960); and *Communications Workers of America, AFL-CIO, et al.* v. *NLRB,* 362 U.S. 479 (1960).

CONCLUSION

It is respectfully submitted that the Decision, insofar as it finds either of the unions guilty of violating Section 8(b) (4) (A) or (B), should be reversed and the case dismissed if the Court agrees with any *one* of the basic arguments made herein by the unions.

If the court agrees with none of the arguments, then it is respectfully submitted, in that alternative, that the scope of the Order should be modified to strike therefrom the words "or any other employer" wherever they appear.

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By.....
A. D. WARD

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

.....

April, 1963

APPENDIX A

Material parts of Exhibit 44, the Arizona Master Labor Agreement:

MASTER LABOR AGREEMENT

Labor Agreement between the Associated General Contractors, Arizona Chapter; Arizona Building Contractors, Building Chapter, Associated General Contractors; Phoenix Association of Home Builders; Arizona Consolidated Masonry and Plastering Contractors' Association; Community Home Builders' Association and Building and Construction Trades Unions.

THIS AGREEMENT entered into this 27th day of May, 1959, by and between the members of the ASSOCIATED GENERAL CONTRACTORS, ARIZONA CHAPTER; ARIZONA BUILDING CONTRACTORS, BUILDING CHAPTER, ASSOCIATED GENERAL CONTRACTORS; PHOENIX ASSOCIATION OF HOME BUILDERS; ARIZONA CONSOLIDATED MASONRY AND PLASTERING CONTRACTORS' ASSOCIATION AND COMMUNITY HOME BUILDERS' ASSOCIATION, who are signatories hereto and employers, non-members, who are signatory hereto, parties of the first part, hereinafter referred to as the Contractors.

and the

Laborers' District Council of the State of Arizona including Locals 479, 383 and 556;

Construction Locals in the State of Arizona of the United Brotherhood of Carpenters and Joiners of America including Locals 1089, 2402, 906, 1216, 1538, 1100, 1914 (Millwright), 471, 857, 2096, 1153, 445 and 326;

Locals No. 83 and 310 affiliates of the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America;

Operative Plasterers' and Cement Masons' International Association, Local Unions No. 394 and 395;

who are signatory hereto, for themselves, for their various Craft Councils and Local Unions which have jurisdiction over the work in the territory hereinafter described, parties of the second part, hereinafter referred to as the Unions.

WITNESSETH:

PURPOSES:

WHEREAS, the CONTRACTORS are engaged in contract construction work in Arizona; and

WHEREAS, in the performance of its present and future contracting operations the CONTRACTORS are employing and will employ large numbers of workmen represented by various UNIONS, and

WHEREAS, the CONTRACTORS desire to be assured of their ability to procure employees for all of the work which they may do in the area hereinafter defined as Arizona in sufficient numbers and skill to assure continuity of work in the completion of their construction contracts; and

WHEREAS, it is the desire of the parties to establish uniform rates of pay, hours of employment and working conditions which shall be applicable to all workmen performing any work for the contractors, as such work is hereinafter defined in ARTICLE III of this Agreement.

NOW, THEREFORE, in consideration of the premises and of the respective covenants and agreements of the parties hereto, each of which shall be interdependent, IT IS HEREBY AGREED:

Article I

COVERAGE

A. That this Agreement shall apply to and cover all employees of the contractors employed to perform or performing construction work as such construction work is more particularly defined hereafter in Article III of this Agreement, in the area known as the State of Arizona, except those employees exempted from the provisions hereof by Article II of this Agreement; and the contractors

shall not offer or grant to any individual employee or group of employees whomsoever, performing any work mentioned in Article III of this Agreement, any less favorable terms and conditions of employment than provided for by this Agreement.

B. That all work performed by the CONTRACTORS, and all services rendered for the CONTRACTORS, as herein defined, by employees of the CONTRACTORS, shall be rendered in accordance with each and all of the terms and provisions hereof.

C. That if the Contractors, parties hereto shall subcontract construction work as defined hereafter in Article III of this Agreement, the terms of said Agreement shall extend to and bind such construction subcontract work, and provisions shall be made in such subcontract for the observance by said subcontractor of the terms of this Agreement. A subcontractor is defined as any person, firm or corporation who agrees under contract with the general contractor or his subcontractor to perform on the job site any part or portion of the construction work covered by the prime contract, including the operation of equipment, performance of labor and the furnishing and installation of materials. The prime contractor shall comply with the State Law regulating contracting which requires posting of notices.

D. That in no event shall the Contractors be required to pay higher rates of wages, or be subject to more unfavorable working rules than those established by the respective Unions for any other employer engaged in similar work in Arizona.

E. When the manufacturer's warranty covers the repairing or adjustment of equipment or machinery the terms of this contract shall not apply. However, in the cast of tire servicing, this exemption shall not apply when workmen are assigned for more than four hours continuously.

F. That the Contractors and their subcontractors shall have the choice in the purchase of materials, provided that they shall give preference to the use of materials, supplies or equipment which will not cause any discord or disturbance on the project between the parties hereto.

G. That all work performed in the Contractor's warehouses, shops or yards which have been particularly provided or set up to handle work in connection with a job or project covered by the terms of this Agreement, shall be subject to the terms and conditions of this Agreement. However, all work performed in other warehouses, shops or yards of the Contractors or subcontractors shall not be subject to the terms and conditions of this Agreement except the production or fabrication of materials used upon the project. This Agreement shall not prevent the employer from negotiating or making Agreements with the Unions for any work or classifications not covered by this Agreement provided that in the course of such negotiations, none of the work covered by this Agreement outside the permanent home yard, shop or warehouse shall be interfered with; and provided further that equipment and materials in permanent home yards, shops or warehouses at the time of the negotiations and/or dispute shall be allowed to be removed from the permanent home yards, shops or warehouses to construction projects being performed by that Contractor whose permanent home yard, shop or warehouse is involved in the dispute or negotiations.

Article III

WORK COVERED

A. The Construction of, in whole or in part, or the improvement or modification thereof, including any structures or operations which are incidental thereto, the assembly, operation, maintenance and repair of all equipment, vehicles and other facilities used in connection with the performance of the aforementioned work and services and including, but not limited to, the following types or classes of work:

B. Street and Highway work, grading and paving, mechanical land leveling, excavation of earth and rock, grade separations, elevated highways, viaducts, bridges, abutments, retaining walls, subways, airport grading, surfacing and drainage, electric transmission line and conduit projects; water supply, water development, reclamation, irrigation, drainage and flood control projects, water

mains, pipe lines, sanitation and sewer projects, dams, tunnels, shafts, aqueducts, canals, reservoirs, intakes, channels, levees, dikes, revetments, quarrying of breakwater or riprap stone; foundations, pile drivings, piers, locks, dikes; river and harbors projects; breakwaters, jetties and dredging; warehouses, shops and yards, the construction, erection, alteration, repair, modification, demolition, addition or improvement, in whole or in part of any building structure, including oil and gas refineries and incidental structures, also including any grading, excavation, or similar operations which are incidental thereto, or the installation, operation, maintenance and repair of equipment, and other facilities used in connection with the performance of such building construction.

C. The parties agree to jointly take steps to assure that all Federally authorized construction projects, including electric transmission lines, conduit projects, and substations, shall specify that prevailing rates of pay be paid.

Article V

* * *

C. That in the event any grievance or dispute except a grievance or dispute concerning referral in the first instance (see Article II-D), is not satisfactorily settled by the employee or his representative and the superintendent in charge within twenty-four (24) hours from the time it is reported, it shall be referred to the business or special representative of the appropriate Union or Unions. Said business or special representative shall then attempt to adjust said grievance or dispute with the Contractor performing the work. If said grievance or dispute is not satisfactorily adjusted by said business or special representative and the Contractor within three (3) days from the date the grievance or dispute arose, it shall be referred to the Area Joint Labor-Management Committee, in the appropriate area, provided that a representative of the craft and a member of the construction firm involved in the controversy may represent his respective organization at the hearing. The said Area Joint Labor-Management Committee shall then hear and review any grievance or dispute submitted to it and adjudicate

the same. The decision of said Area Labor-Management Committee shall require an affirmative vote of not less than a majority of the Committeemen, and shall be final and binding upon all parties to this Agreement, except decisions appealed to the State Joint Conference Board from either party in which its decision shall be final and binding upon all parties to this Agreement. In the event the Area Joint Labor-Management Committee fails to render a decision within three (3) days after the grievance or dispute is submitted to it, the Secretary of the Area Joint Labor-Management Committee to which the grievance or dispute has been referred will submit the same to the State Joint Conference Board. In the event that the required majority of the Committeemen cannot be secured within three (3) days after the submission of the said grievance or dispute to said State Joint Conference Board, such Committeemen shall, upon request of any party to the grievance or dispute, select an additional person who shall act as arbiter and all of the parties hereto agree that the decisions that come from such arbitration shall be final and binding upon them. Any such request from an interested party for selection of an arbiter shall be made within ten (10) days after notification of the failure of the State Board Committeemen to reach a decision; and the State Board Committeemen shall then comply with such request within five (5) days of its receipt.

If, within twenty-four (24) hours after said Committeemen attempt to choose an additional person to act as arbiter, they are unable to agree upon such person, the arbiter shall be chosen in the following manner:

The Director of Federal Mediation and Conciliation Service of the United States shall immediately be requested by said Committee to submit the names of five persons qualified to act as arbiters. When said list has been presented the representatives of the Unions and the representatives of the Contractors shall each have the choice of rejecting the names of two of these five persons, the remaining or fifth one shall be selected as the arbiter within twenty-four (24) hours after submission of said list, and it shall be

mandatory for said arbiter to render a decision within forty-eight (48) hours thereafter unless an extension of time is mutually agreed to by parties hereto. All employee grievances and disputes between the parties regarding the interpretation or performance of any of the terms or conditions of this Agreement shall be submitted to the grievance procedure and arbitration in the manner provided in this section.

There shall be no lock-out by the employer nor cessation of work by the employees, unless there is a violation of this Agreement as determined under the provisions of this Article. This paragraph shall not apply where an employee covered by this Agreement is paid by a check which is returned or is otherwise invalid because of insufficient funds.

Article VI

WAGE SCALES AND WORKING RULES OF THE FOUR BASIC TRADES

The attached hourly wage rates and working rules are hereby referred to and made a part hereof. These wage rates and working rules shall apply to all work covered by the terms of this Agreement and performed by employees of the Contractors whose work classifications come within the jurisdiction of the following Unions:

Laborers' District Council of the State of Arizona..Appendix A

Section 1—General
Section 2—Mason Tenders
Section 3—Plasterer Tenders
Section 4—Tunnel & Shaft Workers
Sections 5—Watchmen

Construction Locals in the State of Arizona of the United Brotherhood of Carpenters and Joiners of America .....Appendix B

Locals No. 83 and 310 Affiliates of the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America.....Appendix C

APPENDIX B

Record of exhibits identified and/or received relating to this consolidated appeal:

General Counsel's Exhibits

No.	*Identified*	*Received*
29	p. 125	p. 126
30	125	126
44 (See Appendix A)	203	204

Respondent Unions' Exhibits

No.	*Identified*	*Received*
5	p. 216	p. 238
6	279	280
7	281	
8	411	413
9	411	415
10	411	415

No. 18,224

IN THE

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CLAUDE C. WOOD COMPANY,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Table of Authorities Cited

Cases

Codes

Rules

No. 18,224

IN THE

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COMMISSIONER OF INTERNAL REVENUE,
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vs.

CLAUDE C. WOOD COMPANY,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

Whether the Tax Court erred in holding that the taxpayer "is entitled to deduct percentage depletion on rock, sand and gravel, which it removed from property that had already been dredged-mined for gold." (R. 59.)

STATUTE INVOLVED

The applicable statute is set forth in Appendix A of the brief for petitioner.

STATEMENT

Respondent herein conducts a rock, sand and gravel business on three properties that had previously been dredged-mined for gold by Gold Hill Dredging Company. The properties are commonly referred to as the "Featherston," "Putnam," and "Wright."

The Tax Court found, inter alia:

(a) "The Putnam, Wright, and Featherston properties had never been mined for aggregates by Gold Hill Dredging Company or any prior owners, and no aggregates were removed from these properties until the operations were commenced by petitioner." (R. 62.)

(b) "Respondent produces approximately 15 kinds of rock and sand products." (R. 67.)

(c) In the process of removing the gold from the sand and aggregates the gold-dredge did not crush or change the size of the aggregates, nor were any chemicals added in the process. (R. 65.)

I

THE INTERNAL REVENUE CODE GRANTS A FIVE PER CENT DEPLETION ALLOWANCE IN CASE OF MINERALS OR OTHER NATURAL DEPOSITS OF GRAVEL, SAND, ROCK, ETC.

The Internal Revenue Code of 1954, Section 611 (a) provides that in the case of mines or other "natural deposits" there shall be allowable as a deduction in computing taxable income a reasonable allowance for depletion. Section 613 (b) of the Internal Revenue

Code, 1954, grants a five per cent depletion allowance in the case of mines and other "natural deposits" of gravel, sand, riprap, road materials, concrete aggregates, or for similar purposes.

The deficiency notice mailed by petitioner to taxpayer stated in part as follows:

> "It is determined that on the mining of aggregates from tailings, which results from the acquisition of the right to remove sand and gravel from the residue of prior gold dredge-mining along the Mokelumne River on the property of the Gold Hill Dredging Company, no percentage depletion is allowable pursuant to the provisions of the Internal Revenue Code.
>
> "It is held that once a deposit has been mined the residue does not revert to a natural deposit; therefore the aggregates subsequently were not removed from 'natural deposits' . . .". (R. 14, 15.)

In the brief presented by petitioner prior to the decision of the Tax Court under the heading "Question Presented" we find the following:

> "Did petitioner's business consume *natural deposits* of rock, sand and gravel when it consumed rock, sand and gravel from property that had been dredged-mined for gold?" (Emphasis added.)

Based upon the foregoing statements, the theory upon which the case was actually tried before the Court was correctly summed up by the Court when it stated:

> "The issue, as stated by respondent, is: 'If the rock, sand, and gravel located on these properties

qualify as a natural deposit or mineral-in-place, then petitioner is entitled to a deduction for depletion.' " (R. 70.)

II

THE TAX COURT'S FINDINGS OF FACT SHALL NOT BE SET ASIDE UNLESS CLEARLY ERRONEOUS.

The Tax Court, after hearing all of the facts and evidence presented (incidentally, the Commissioner presented no testimony or witnesses at the trial) and after having read the briefs that were presented by the respective parties the Court concluded and *found,* in addition to the above findings, that, *as a fact:*

> "The aggregates taken from the Putnam, Wright, and Featherston properties in the year in question were *natural deposits that were mined* by petitioner." (R. 67; emphasis added.)

Petitioner now urges that the Court's finding that the aggregates were natural deposits is not binding on this Court. In disagreeing with the Tax Court, the Commissioner seems to forget that fact finding is the business of that Court. "It is for the trial Court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs." *United States v. Cumberland Public Service Co.,* 338 U.S. 451, 456 (1950). Furthermore, in the familiar words of Rule 52 (a) of the Federal Rules of Civil Procedure, "findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial judge to judge

of the credibility of witnesses." Under Rule 52 (a) findings of fact may not be easily discarded even if the facts might have been differently found. *United States v. Real Estate Boards,* 339 U.S. 485, 495 (1950); *United States v. Yellow Cab Company,* 338 U.S. 342 (1949); *Stout v. Commissioner,* 185 F. 2d 854 (6th Cir. 1950). A finding is "clearly erroneous" only when "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. Gypsum Co.,* 333 U.S. 364, 395.

Petitioner would have this Court ignore the foregoing established principles of law by suggesting that the Tax Court did not apply "the proper legal standard established by statute." It is submitted that this suggestion is untenable and that the facts as found by the Tax Court should not be set aside. The Tax Court having found that the aggregates in question were "natural deposits that were mined by petitioner" and were deposits of a type that qualify under the Code, this entire case should be settled and resolved in favor of respondent without any further question or argument.

III

THE TAXPAYER'S AGGREGATE DEPOSITS WERE "OTHER NATURAL DEPOSITS" WITHIN THE MEANING OF THAT TERM IN SECTIONS 611 AND 613.

The precise issue presented to this Court has been decided adversely to petitioner not only by the Tax Court in this case, but also in *Pacific Cement & Ag-*

gregates v. Commissioner, 31 T.C. 136 (October 23, 1958). The Court will note that in the Memorandum Findings of Fact and Opinion (R. 59 at R. 68) *Pacific Cement* is referred to as being almost identical in facts to the present case and the Court quotes from its decision at pages 139, 140 and 141. This Tax Court has therefore *found* against petitioner on two occasions, *as a fact,* that producers, processors, or miners, of aggregates that had been previously dredge-mined for gold are entitled to a depletion allowance as a "natural deposit."

Petitioner attempts to make the *Atlas Milling Co. v. Jones,* 115 Fed. 2d 61 (C.A. 10, 1940) ((40-2 USTC 9711)), and *Consolidated Chol. G. & S.M. Co. v. Commissioner,* 133 Fed. 2d 440 (C.A. 9, 1943) ((43-1 USTC 9298)) apply to the present case. Both of these cases had been decided prior to *Pacific Cement* and the two cases were discussed by the Court in the *Pacific Cement* decision and in reviewing these two cases the different factual situation was noted and the Court stated:

> "In the Atlas Milling Co. case, the mineral was mined and removed to the mill where it was processed and the ore extracted. The residue was dumped and it was this residue which was acquired by the taxpayer in that case and reworked by a more modern process. The Court held that such residue was not a mine and the reprocessing of it was not the working of a mine and pointed out the fact that the taxpayer there had no interest in the mine from which the ore had originally been taken. The petitioner in the *Con-*

> *solidated Chollar Gould* case, supra, had claimed percentage depletion 'from the extraction of gold by the petitioner from certain dumps consisting of rocks and ore material which had never been milled or processed in any way but which had been deposited upon lands owned by the petitioner ((from mines not located on such lands)) many years prior to the acquisition of said lands by the petitioner.' "

It is interesting to note that petitioner's brief nowhere refers to the California case of *State of California v. Natoma Company,* 25 Cal. Rptr. 363, 208 ACA 711, decided in October, 1962. The lands in controversy had been dredged-mined for gold between 1900 and 1925 and the question presented to the Court was whether the dredger tailings remaining after the gold had been removed was realty or personalty for the purposes of condemnation. The Court held the aggregates to be realty. Had the Court considered the aggregates a "waste," a "residue," a "dump" etc., it would have held it to be personalty.

The language quoted from the cases cited by petitioner in support of its position are misleading. In the *Atlas, Kohinoor Coal, Soil Builders,* etc., the product created by nature was changed in size, shape or content by mechanical, chemical or other methods when ore was extracted. The Court makes this point abundantly clear in *Pacific Cement* when it states:

> "In the instant case there is nothing that resembles a dump or residue remaining after the ore has been milled and the concentrates removed

therefrom. The aggregates on the Fair Oaks property cover an extended area southward from the banks of the American River and are the identical aggregates which were placed in the area by nature, the only difference being that petitioner's predecessor in interest operated by dredge on the deposit as it existed, picking up the sand and gravel, extracting the gold therefrom, and dumping the sand and gravel, minus the gold, in substantially the same place where it had picked it up. *There has been no prior mining* of the Fair Oaks property *for the purpose of extracting aggregates* and *there has been no change in the size or form of the aggregates.* When 'Natomas Company completed its process *they were the identical aggregates which existed when the process had been commenced.* Petitioner leased the Fair Oaks property and worked the identical deposit for aggregates for the first time and in the place where the sand and gravel had been originally laid down by nature. The fact that, in extracting the gold, the sand and gravel had been stirred up does not warrant respondent in taking the position that petitioner was not working a natural deposit in place or that petitioner did not have an economic interest in the very property from which the deposit was being extracted. In our opinion, the rock, sand, and gravel recovered by petitioner from the Fair Oaks property *were from 'natural deposits' and constituted 'minerals in place'* as those terms are used in the statutes and regulations previously cited.

"In conclusion, we hold that the respondent erred in disallowing depletion claimed by petitioner on the Fair Oaks property." (Emphasis added.)

There are no tailings or waste material and low-grade ore placed on the surface of the Putnam, Wright and Featherston properties. The entire deposit of aggregates constituted a natural deposit which had been placed there by nature eons ago. The deposit had been slightly disturbed by the extraction of gold, but the deposit of aggregates, as such, remained as originally created by nature.

As previously stated the main issue to be determined in this case is whether the aggregates in question are "a natural deposit," if they are so found to be then the depletion allowance must be permitted to taxpayer. If the aggregates in question are not "natural deposits" then of necessity they are "waste or residue of prior mining." In attempting to argue that the aggregates are "waste or residue of prior mining" at page 20 of the brief of the petitioner, the *Consolidated* opinion is referred to by counsel to the effect that "mere severance and piling of ore-bearing rock, without the extraction of a mineral, was sufficient to make the mine tailings residue." This is a misleading statement without a full statement of the facts. The ore in the *Consolidated* case was dug or removed from the property of one person some distance away to the property of another person. The extraction and mining of the ore did not take place until after the material had been deposited on the second persons' property. Clearly, when the mining took place it was not a "natural deposit." As previously set forth the Court in *Pacific Cement* noted and made this factual distinction between the *Consolidated*

cases and the case where the prior operation was gold dredge-mining. The brief at page 20, again attempts to confuse the issue by stating that in the instant case the "gold was extracted from the ore-bearing aggregates." The attempt is being made to create the impression that the gold was imbedded in the aggregates and had to be extracted therefrom. The uncontrovertible evidence and testimony was that the gold in question was "free placer gold." (R. 90.) The operation of the dredger merely extracted the free gold from amongst the sand.

The Court's attention is called to petitioner's brief, page 14, wherein *Cordell v. Scofield* (D.C. Tax, 1958), 58-2 USTC is cited only. The reason is obvious. In this case clay, sand, and other materials were dredged from a ship channel and piped to properties of a navigation district and deposited behind levees for disposal. Taxpayers (a partnership) mined the clay and sand from the properties under leases with the navigation district and processed the clay into burnt brick and tile. The Commissioner denied the partnership a depletion deduction contending that the clay and sand were not natural deposits. The Court held that the partnership's *clay mining operation did not differ in any way* from any other clay mining operation conducted by a brick company and, accordingly, allowed depletion on the clay. The Court found:

> "The clay deposit in the 'Old Filter Bed Tract' was dredged and piped behind levees in about 1918 when the Houston Ship Channel and turning Basin were deepened and widened. There

> was overburden on the clay in the 'Old Filter Bed Tract' in 1938 and subsequently. By 1938, heavy vegetation had grown on the land, including quite a bit of timber, with trees as large as 20″ in diameter at the trunk. This overburden had to be removed in order to mine the clay in the same way that other clay deposits are mined.
>
> "The mining operation conducted by the partnership in the 'Old Filter Bed Tract' did not differ in any way from any other clay mining operation conducted by a brick company."

The Court also held that depletion was allowable in connection with the sand, which had been deposited during the widening and deepening of the ship channel.

The last cited case appears to be the only one where a natural deposit has been entirely removed from its original place and is still considered a natural deposit in the new place. The Putnam-Wright-Featherston natural deposit has not been removed and *a fortiori* remains a natural deposit in its original place.

The Fifth Circuit Court of Appeals in April, 1960, in the case of *Soil Builders, Inc. v. United States of America,* 227 F. 2d 573, considered the question of granting a depletion allowance in the mining of the property for hard phosphate which mining resulted in the creation of a colloidal or soft phosphate a quarter to a half mile downstream from the operation. The mining of the hard phosphate was accomplished by removing from a frame or block of hard phosphate the sand, clay, and soft particles of phosphate from

the openings in the blocks. The Court found that the original mining was of phosphate rock and that the mining operation then before the Court was for colloidal or soft rock phosphate. The Court reviews the *Atlas Milling Co. v. Jones* (supra) and other cases and notes that in all of these cases the reworking activity was to recover more of the same mineral that had been the object of the original mining. The Court stated:

> "The colloidal phosphate not only is not in its natural location; it is not even in its natural state. In effect, it is a refined product, refined by the removal from it of all sand (silicon dioxide) and non-phosphate clay. The refinement process and the removal process were one and the same. By this process a deposit was undoubtedly made but it was not a natural deposit; it was man made."

At page 15 of the brief for petitioner the *Soil Builders* case is cited as authority for petitioner's argument, and it is therein stated:

> "The mining processes engaged in there were quite similar to those in this case."

It is respectfully submitted that only a cursory reading of the facts in the *Soil Builders* case and the testimony in the case before the Court conclusively demonstrate that there is no similarity in the two mining processes. Furthermore the brief fails to call this Court's attention to the fact that the *Soil Builders* case, *Pacific Cement & Aggregates, Inc. v. Commis-*

sioner (Supra) was discussed and the factual situation in this latter case reviewed by the Court. In other words, *Soil Builders did not overrule, change, or modify the decision made* in *Pacific Cement & Aggregates, Inc. v. Commissioner*, but distinguished the facts in this latter case from all other decisions that had theretofore been decided *and in fact approved the decision of Pacific Cement & Aggregates v. Commissioner.* The Court concluded that the facts in this *Pacific Cement* case were distinguishable from the *Soil Builders* case in that "(1) that the taxpayer claims a deduction under the classification of phosphate rock, which is exactly what was previously mined, and (2) that the colloidal phosphate here was not, when removed, either a natural deposit or in its natural state."

The foregoing cases, except the *Pacific Cement & Aggregates* case, have been cited to indicate that in each one of them there was involved a tailings pile, a refuse pile, a pile of waste or a culm or refuse bank, or some other similar residue of ore resulting from previous mining operations. In each of the cases the ore in question had been removed from the ground, the ground was processed by mechanical or chemical methods and the remaining ground was deposited on the surface of the earth outside of the mine from which it was extracted.

In the case before the Court there is nothing that resembles a refuse or tailings pile or a residue of low-grade ore resulting from prior mining operations, a culm bank or refuse bank, or any other type of residue

from prior mining operations. The aggregates in this case are the identical aggregates which were placed in the area by nature, the only difference being that the gold had been extracted from the sand, and the aggregates were thereupon returned to the surface of the earth at a distance of approximately 150 feet from their original position. There has been no change in the size or form of the aggregates. In going through the dredge the aggregates were only washed. They were not treated chemically, nor were they crushed in any way. When the dredging operation was completed, the aggregates were the identical aggregates which existed when the process had been commenced. The gold was "free gold" in the sand, and the sand remained after the gold dredging operation had been completed. (R. 90.)

The testimony of Herbert L. Coney, the person who constructed and operated the dredge in question, respecting the foregoing statements is as follows (R. 90):

> "Q. Now, this gold in effect that has floated or been washed down from the Sierras, is that correct?
>
> A. That is correct.
>
> Q. This gold that you dredge-mined, in what state was that gold? Is it embedded in the rocks or aggregates?
>
> A. No. It is a free placer gold.
>
> Q. It is a free placer gold?
>
> A. That is correct.
>
> Q. It is not affixed or——
>
> A. No.

Q. So that the process of the gold dredge is to wash the sand and separate the gold from it so that the gold will drop, is that kind of——

A. That is correct.

Q. ——a layman's description of it?"

Mr. Coney's testimony regarding what happens to the aggregates themselves when they go through the dredge, the Court's attention is called to his testimony in this regard at R. 91 and R. 92.

"Q. Now, when the aggregates are discharged over the stacker conveyor at the stern, what if anything is done to the aggregates by the dredger?

A. Well, nothing. They are merely floating lodes on through. They don't change their shape in any form. They're merely dug and they're washed as they go through the screen, and that is the only thing that is done to them.

Q. What, you say they were a floating what?

A. A floating load going through the trammel in there.

Q. In other words, there is no machinery or anything on the dredger that crushes any of these aggregates?

A. No.

Q. There are no cemicals added to them?

A. No.

Q. Are they in the same physical shape, size and content when they are picked up by the bucket line as they are when they are discharged over the stacker conveyor?

A. That is correct.

Q. The difference is that instead of them being in front of the dredge at the time they are

picked up, they are then deposited to the rear; is that correct?

A. That is right. They are transported the length of the dredge, that is all.

Q. And that is the only thing that happens?

A. That is all.

Q. Is that the only thing that happens to them?

A. That is the only thing that happens to the aggregates.

Q. Now, would you briefly describe to the Court what [23] happens to the ground when you go in and gold dredge it?

In other words, you've got some terrain, a gold dredger goes in, and when you operate you move out, and what has happened?

A. Well, the simplest explanation I could give to the Court would be that we merely turn the ground upside down. What is on top when we are finished is on the bottom.

Q. You mean what was on the top when you started is on the bottom when you have finished; is that correct?

A. That is correct.

Q. And it has been moved the length of the dredger?

A. Of the dredger.

Q. And other than that, is there any change to the shape and size of the aggregates that go through the dredger?

A. None at all."

The disturbance of the aggregates caused by the gold dredge did not destroy them as a natural deposit. When the dredge mining operation was completed, the

aggregates were returned to the earth in approximately the same location as they had been previously. They were not in any way processed as aggregates, nor had they been mined as aggregates. Also, no other person, firm, or corporation, worked or operated these properties for the removal of aggregates except petitioner. (R. 93, 120, 121.) The Tax Court so found. (R. 62.)

The Court held in the *Atlas Milling Co.* (Supra) and similar cases that the material there worked on by the taxpayer, for which a depletion allowance was not granted, was not a material that was a natural deposit. Those materials upon which the taxpayers were working were in different form, shape, size, and content than that created by nature. Those materials had been "worked over" by man, and the refuse remaining cannot be classified as a natural deposit. *In the instant case*, however, *the aggregates worked on by taxpayers were in exactly the same form, size, shape, and relative location as created by nature.* The aggregates in question had never been processed, worked on, or mined by any person prior to the time taxpayer commenced its operations. These aggregates are natural deposits, and petitioner is entitled to a percentage depletion allowance in accordance with the language of the Code.

IV

WHETHER TAXPAYER WAS A "PURCHASER" OF THE AGGREGATES IS IMMATERIAL.

The final point made in the brief for the petitioner is that the taxpayer was the *purchaser* of the aggregates in question, and that the Tax Court did not consider this point. The brief refers to the aggregates, however, as "waste or residue" and being "waste or residue" of prior mining under the regulations, a depletion allowance should not be permitted. As set forth above it is the position of taxpayer that he was not the purchaser of "waste or residue" of prior mining, but rather the purchaser of natural deposits.

The Tax Court decision did consider the fact that taxpayer was a purchaser of the aggregates in question. The three agreements to purchase are summarized and reviewed by the Court in its Memorandum of Findings. (R. 59 to 62.)

As will be noted from a reading of the decision of the Tax Court in its opinion herein, *Pacific Cement* is quoted with approval and particular reference is made to the following language. (R. 69.)

> "* * * We think there might be some reason for the respondent's contention if the property was being worked for aggregates, it does not seem reasonable to say that such aggregates were in the nature of "mineral dumps artificially deposited from the residue.* * *"
>
> "* * * The aggregates on the Fair Oaks property cover an extended area * * * and are the identical aggregates which were placed in the area by nature, the only difference being that petitioner's

predecessor in interest operated by dredge on the deposit as it existed, picking up the sand and gravel, extracting the gold therefrom, and dumping the sand and gravel, minus the gold, in substantially the same place where it had picked it up. There has been no prior mining of the Fair Oaks property for the purpose of extracting aggregates and there has been no change in the size or form of the aggregates. * * * Petitioner leased the Fair Oaks property and worked the identical deposit for aggregates for the first time and in the place where the sand and gravel had been originally laid down by nature. The fact that, in extracting the gold, the sand and gravel had been stirred up does not warrant respondent's taking the position that petitioner was not working a natural deposit in place or that petitioner did not have an economic interest in the very property from which the deposit was being extracted.* * *''

Substitute the names of Featherston, Putnam and Wright for the words "Fair Oaks" and the factual situation is identical.

Finally, the Tax Court *did* actually find (and not "purportedly") as stated in the brief for petitioner (Pg. 28) that "The aggregates taken from the Putnam, Wright and Featherston properties in the year in question were '*natural deposits that were mined by* petitioner'." (R. 67; emphasis added.)

The arguments made in petitioner's brief were submitted and argued to the Tax Court in this case and presumably to the Tax Court as well in the *Pacific Cement* case and in both cases the Court con-

cluded and found *as a fact* that the aggregates "were natural deposits that were mined by petitioner," (R. 67) and that the depletion deduction should be allowed.

Dated, Lodi, California,
April 3, 1963.

Respectfully submitted,
ROBERT H. MULLEN,
Attorney for Respondent.

CERTIFICATE OF SERVICE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

ROBERT H. MULLEN,
Attorney for Respondent.

No. 18,224

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAUDE C. WOOD COMPANY, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE PETITIONER

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INDEX

CITATIONS

Cases:

Statutes:

Miscellaneous: Page

In the United States Court of Appeals for the Ninth Circuit

No. 18,224

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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On Petition for Review of the Decision of the Tax Court of the United States

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BRIEF FOR THE PETITIONER

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 59-70)[1] are not officially reported.

JURISDICTION

This petition for review (R. 56-58) involves federal income tax for the taxable year 1958. On May 27, 1960, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in in-

[1] Record references are to the printed Transcript of Record.

come tax in the total amount of $9,347.35. (R. 12-16.) Of this amount, $8,760 is in controversy. (R. 5, 59.) Within ninety days thereafter, on June 22, 1960, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code. (R. 3, 5-16.) The decision of the Tax Court was entered April 9, 1962. (R. 55.) This case was brought to this Court by a petition for review filed June 27, 1962. (R. 56-58.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in holding that the taxpayer is entitled to a percentage depletion allowance under Sections 611 and 613 of the Internal Revenue Code of 1954 on tailings of sand, gravel and cobbles remaining from gold dredge mining operations.

STATUTE INVOLVED

The applicable statute is set forth in Appendix A, *infra*.

STATEMENT

The facts of this case, drawn from the stipulation of facts. (R. 19-21), exhibits (R. 21-54),[2] testimony

[2] The parties stipulated, with the approval of the Court, to exclude several of the exhibits from the printed record. (R. 139-140.)

(R. 71-138), and findings of the Tax Court (R. 59-67) may be stated as follows:

The taxpayer, Claude C. Wood Company, a California corporation, operates a rock, sand and gravel business. (R. 59.) In 1958, the taxable year in question, it operated from the Featherston, Putnam Ranch and Wright properties in San Joaquin County, California. (R. 19-20.) Its operations on all three properties were carried out under agreements which gave it the exclusive right to remove the rock, sand and gravel which had been unearthed in prior gold dredging operations on the land. (R. 33-49.)

The agreement relating to the Featherston properties under which the taxpayer operated provided that the taxpayer would purchase all the sand and gravel removed from the owner of the property at a stated rate per ton, subject to an agreed minimum payment. (R. 34-35.) The agreement under which the taxpayer operated on the Putnam Ranch property was similar in this respect. (R. 39-42.) The agreement under which the taxpayer operated on the Wright property provided that the owners of the property sold to the taxpayer for $9,375 all rock, gravel and sand remaining on the property after previous dredging operations. (R. 43-48.) The taxpayer operated under these agreements during the taxable year in question. (R. 59-62.)

The gold dredging operation preceded the taxpayer's operations on the properties. Before the dredging operation commenced, the general geologic cross section of the properties was bedrock on top

of which was an alluvium deposit 30 to 40 feet thick. (R. 89, 94, 103.) The alluvium contained aggregates of sand, gravel and cobbles.[3] (R. 62-63.) When in place as an alluvial deposit, sand and fine gravel filled the voids between the cobbles. (R. 63, 90, 96.) Free gold was also intermingled with the sand, gravel and cobbles. (R. 90.) On top of the aggregates was a layer of topsoil and vegetation. (R. 62-63.)

In determining whether a property was suitable for dredge mining for gold, borings were taken to determine the gold content, the character of the subsurface, and the depth at which bedrock lay. (R. 63, 85, 94.) If the property was acceptable, the topsoil and vegetation were removed to expose the alluvium. (R. 65, 100.) A pit was then dug in which the dredge was constructed on a watertight platform. (R. 63, 85.) The pit was flooded to float the barge. (R. 63, 64.)

The dredge was a ponderous machine. (See Ex. 9-I.) The barge was 150 feet long. (R. 64.) Extending forward from it was a digging ladder 75 feet long bearing scoops on a conveyor belt which dug and carried the gold-bearing aggregates to the barge. (R. 64, 87-88.) Extending backward from the platform was a stocking ladder, an arm 125 to 150 feet long, which conveyed gravel and cobbles from the barge to deposit them behind the barge. (R. 64, 66.)

The dredge in operation scooped up all the material above bedrock with the scoops at the end of its digging

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[3] Cobbles are rounded stones from 4 to 12 inches in diameter. (R. 127-128.)

ladder and conveyed the material to the barge. (R. 65, 87-89.) There, the aggregates were tumbled in a trammel, a cylinderical rotating perforated screen, in which they were washed and screened to separate the small particles of gold and sand from the unwanted gravel and cobbles. (R. 65, 88-89.) The gravel and cobbles were then conveyed 150 feet backward to the end of the stacking arm and dumped. (R. 87, 88, 96-100.) Quicksilver separated the gold from the fine sand with which it had passed through the trammel screen and the sand was discharged into the pond immediately behind the barge. (R. 65, 88-89, 91, 96-100.) Thus, the gravel and cobbles were moved from their original position at any given point on the property some 300 to 350 feet while the sand from the same place was moved about 200 to 225 feet. (R. 64, 91, 92, 96-97, 98.) The dredge dug its way about the property by displacing the material in front of it and depositing it behind. (R. 66, 85, 86, 89-90.) The sand was discharged closest to the machine while the cobbles and gravel were later deposited on top as the dredger moved forward. (R. 66, 89-90, 118.) Since the voids in the gravel and cobbles deposited by the dredger were not filled with sand as in their natural state, the volume or "swell" of the discharged aggregate was 35 to 40 percent greater than it had been in the natural state. (R. 66, 96.)

The cross section of property which has been worked by a dredger of this sort is bed rock, covered by a layer of sand which in turn is covered by a layer of gravel and cobbles with no covering of topsoil.

The dredge's function was one of separation and displacement rather than crushing or grinding of the aggregates it dug. No chemicals were added to the aggregate. (R. 65, 91.)

The deposits remaining after the dredge had worked a property are customarily called a tailing pile. (R. 66, 114, 117.)

As noted above, the taxpayer purchased these dredger tailings. It dug them from the place in which the dredging operation deposited them with draglines and hauled them to its plant for processing. (R. 66, 125.) At the plant the sand, gravel and cobbles were processed into the kinds of rock and sand products which the taxpayer sells.[4] (R. 66-67, 125-127.)

The taxpayer's processing operations differ for dredged and natural aggregate materials. With natural materials sand and rock are mixed, but with dredged materials they have been separated. (R. 67, 130-131, 134.)

On its 1958 income tax return the taxpayer claimed a percentage depletion deduction of 5 percent on the material from the three properties. The Commissioner disallowed the deduction and the taxpayer petitioned the Tax Court. (R. 6, 14-15, 67.) The court decided the taxpayer was entitled to the deduction. (R. 55.) The Commissioner petitioned for this review of that decision. (R. 56-58.)

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[4] The taxpayer sells concrete sand, plaster sand of various sorts, pea gravel used for driveways, crushed rock for highway use, concrete aggregate, septic drain rock, crushed rock for making concrete blocks and turkey grits, sand for tomato seed beds, and rock for fill material. (R. 54, 67.)

SPECIFICATION OF ERRORS RELIED UPON

The Tax Court erred—

1. In finding that the aggregates taken by the taxpayer from three properties in 1958 were natural deposits. (R. 67.)

2. In concluding that the taxpayer is entitled to a percentage depletion deduction on rock, sand and gravel which it removed from property that had already been dredge-mined for gold. (R. 68-70.)

3. In failing to hold that the aggregates were taken from the waste or residue of prior mining (a matter which the court did not discuss).

4. In failing to hold that the taxpayer was the purchaser of waste or residue or of rights to extract mineral therefrom and therefore expressly prohibited from obtaining a percentage depletion allowance under Section 613 of the Internal Revenue Code 1954 (a matter which the court did not discuss).

5. In entering decision in favor of the taxpayer and failing to enter decision in favor of the Commissioner. (R. 55.)

SUMMARY OF ARGUMENT

1. The 1954 Code allows percentage depletion in the case of "mines and other natural deposits." The term "mines" (and by statutory inference, "other natural deposits") is specifically defined to include "waste or residue of prior mining" but with an important exception, i.e., that worked by a purchaser of such waste or residue or of the right to extract mineral therefrom. Without discussing this provision, the Tax Court found that the aggregates taken from three properties by the taxpayer were "natural de-

posits" and held that the taxpayer was entitled to percentage depletion on them.

2. The term "mines and other natural deposits" has been in the statute for many years, but prior to the 1954 Code the term "waste or residue of prior mining" did not appear. Nevertheless, questions arose as to whether waste and residue such as tailings piles and ore dumps from prior mining operations could be the subject of a depletion allowance by persons other than the original miners who later extracted minerals from the waste. Several courts, including this one, considered the problem. The issue in those cases was whether such waste or residue deposits were included in the statutory term "mines and other natural deposits." The appellate courts uniformly held they were not.

The decisions outline the tests for determining whether a mineral deposit comes within the term "mines and other natural deposits." In sum, they indicate that a natural deposit did not include a tailings dump deposited on the surface of the land resulting from residue of ore that had been severed and milled; that natural deposits cannot be artificially created or result from prior mining; and that to be a natural deposit, the material must be in its natural location, in its natural state and unrefined by the removal of any materials. The taxpayer's aggregates deposits do not fit these judicial tests, and do not come within the statutory term "other natural deposits."

3. The same decisions which deal with whether waste or residue are natural deposits also consider

what constitutes waste and residue. They show that tailings, ore which has previously been worked, are residue and waste material; and that waste is material thrown aside and discarded from prior mining operations. The aggregates which the taxpayer extracted were found by the Tax Court to be tailings from the dredging operations. Such aggregates were both waste and residue of the prior gold mining operations. They thus fall directly within the statutory term "waste or residue of prior mining operations."

4. The Code, by definition, excludes from the percentage depletion provisions a "purchaser of * * * waste or residue or of the rights to extract ores or minerals therefrom." The taxpayer was such a purchaser. Each of the agreements under which it operated during the taxable year in question provides that the owner of the aggregates sold them to the taxpayer, either for a lump sum or on the basis of amounts extracted. The taxpayer is therefore not entitled to a percentage depletion allowance.

5. The Tax Court's finding that the aggregates were "natural deposits" is not binding on this Court. In making that finding, the Tax Court failed to apply the proper test of "natural deposits" and compounded its error by failing to recognize and apply the legislative intent with respect to the waste or residue of prior mining. Moreover, even if the court had not erred as a matter of law, its finding that the aggregates were natural deposits, and thus subject to percentage depletion, would be clearly erroneous.

ARGUMENT

The Tax Court Erred In Holding That the Taxpayer Is Entitled To a Percentage Depletion Allowance Under Sections 611 and 613 of the Internal Revenue Code of 1954 On Tailings of Sand, Gravel and Cobbles Remaining from Gold Dredge Mining Operations

A. *Introduction*

Section 611(a) of the 1954 Code (Appendix A, *infra*), permits a deduction for depletion in the case of "mines, oil and gas wells, other natural deposits, and timber." Section 613(a) (Appendix A, *infra*) requires that in the case of "mines, wells, and other natural deposits" the depletion deduction is to be determined on the basis of a percentage of income from the property. The phrase "*other* natural deposits" (emphasis supplied) in both sections demonstrates statutory recognition of the obvious, i.e., that "mines" are a natural deposit, but that they are a specific kind of natural deposit. Stated another way, the Code says, in effect, that all mines are natural deposits, but that not all natural deposits are necessarily mines.

Section 611(a) goes on to provide a specific definition of "mines." It states that, for purposes of the depletion deduction, the term "mines" includes "deposits of waste or residue," but only if the extraction of ores from such deposits is treated as mining under Section 613(c) (Appendix A, *infra*). Section 613(c), relating to percentage depletion, expressly provides that mining includes the extraction of ores or minerals from the waste or residue of prior mining "by mine owners or operators" but that this does not

include any such extraction "by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." [5]

The Tax Court held (R. 67) that the "aggregates taken from the * * * [three] properties * * * were natural deposits that were mined by * * * [the taxpayer]." It did not consider whether the taxpayer was a purchaser of waste or residue. Since the court did not reach the purchaser question, it must necessarily have held (although it did not specifically say so) that the taxpayer's aggregates were "other natural deposits" separate and distinct from "mines" (and from "waste or residue").

We believe it is clear, and will show, that (1) the taxpayer's aggregates were not "other natural deposits"; (2) they were "waste or residue of prior mining"; and (3) the taxpayer was a purchaser of such waste or residue. In the final part of our brief we will point out why the Tax Court's finding that the aggregates were natural deposits is not binding on this Court.

B. *The taxpayer's aggregates deposits were not "other natural deposits" within the meaning of that term in Sections 611 and 613*

Under Sections 23(m) and 114(b)(4) of the 1939 Code, as amended (26 U.S.C. 1952 ed., Secs. 23 and 114) (the predecessors of Sections 611 and 613 of the 1954 Code) percentage depletion was allowed in the case of "mines and other natural deposits." Ques-

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[5] A more extensive discussion of the applicable statutory provisions is undertaken at a later point in this brief.

tions arose as to whether waste and residue, such as tailings piles and ore dumps from prior mining operations, could be the subject of depletion allowances by persons (other than the original miners) who later extracted minerals from the waste.[6] Several courts considered the problem. The issue in those cases was whether such waste or residue was included in the statutory term "mines and other natural deposits."

The judicial exploration of the statutory meaning of the term "other natural deposits" began with a decision of the Tenth Circuit, *Atlas Milling Co.* v. *Jones*, 115 F. 2d 61, certiorari denied, 312 U.S. 686. There, an underground miner brought lead-bearing ore to the surface, crushed it, removed the concentrates and dumped the partially denuded residue in a tailing pile. Later another party came on the land reworked the tailings by a new process and extracted the same material from them. The court concluded that the tailings were not a mine or other natural deposit within the meaning of the statute. It explained its conclusion by saying (p. 63):

> A "mine" is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. * * * Mining connotes the removal of minerals from a natural deposit. It does not embrace the re-working of mineral dumps artificially deposited from the residue remaining after the ore

[6] The 1939 Code did not contain specific reference to "waste or residue."

has been milled and concentrates removed therefrom.

* * * *

While tailings deposited on the surface of land may become appurtenant to the land, they in no true sense become a mine.

We are of the opinion that the word "mines" as used in § 23 [the predecessor of Section 611] * * * is limited to natural deposits and does not include a tailings dump deposited on the surface of the land, consisting of the residue of ore that has been severed and milled.

This Court first considered the problem directly [7] in *Consolidated Chollar G. & S. M. Co.* v. *Commissioner*, 133 F. 2d 440. There, residue from gold mines had been dumped on property other than that on which the mines were located.[8] No ore had been extracted from the residue. The taxpayer acquired the ore dumps some years after mining in the adjacent mines had ceased. The taxpayer began mining the ore from the tailing piles and claimed a depletion deduction. This Court disallowed the deduction, pointing out that even if the ore dumps could be regarded as a mine (p. 441) "they are made by man and not by nature" and therefore were not "other natural deposits."

In *Hoban* v. *Viley*, 204 F. 2d 459, this Court again

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[7] See *Commissioner* v. *Kennedy Min. & M. Co.*, 125 F. 2d 399 (C.A. 9th).

[8] A somewhat more complete statement of the facts appears in the opinion of the lower court, *Consolidated Chollar Gould & Savage Mining Co.* v. *Commissioner*, 46 B.T.A. 241.

considered whether mine tailings were "natural deposits." Mine tailings had been dumped into a stream and deposited by it below the mines. A partnership acquired rights to mine the tailings and claimed a depletion deduction, arguing that the tailings, which had been moved and integrated by the action of a stream for 36 years, were a deposit which was a mine or natural deposit. This Court again denied the deduction saying (p. 461):

> The only natural phenomenon contributing to the creation of the deposit was the action of floods in carrying the tailings downstream * * *.
>
> * * * *
>
> We * * * are of the opinion that the word "mines" or "natural deposits" as used in [the predecessor of Sections 611 and 613] * * * is limited to natural deposits, and does not include tailings severed from mines not owned by the taxpayer, and which are thereafter deposited on the earth's surface.

Contra: *Cordell* v. *Scofield* (W.D. Tex.), decided May 27, 1958 (1 A.F.T.R. 2d 1853).

Other Courts of Appeals have followed the trail assayed by the *Atlas*, *Consolidated* and *Hoban* cases. Thus, in *Chicago Mines Co.* v. *Commissioner*, 164 F. 2d 785, 787, certiorari denied, 333 U.S. 881, the Tenth Circuit denied a depletion deduction arising from the reworking of a mine dump and said (p. 787):

> Mining * * * connotes the removal of minerals from a natural deposit and does not include the reworking of mineral dumps from the surface of

> the earth artificially created and resulting from mining operations.

In *Kohinoor Coal Co.* v. *Commissioner*, 171 F. 2d 880, 885 (C.A. 3d), certiorari denied, 337 U.S. 924, the court held that a taxpayer who had rights to the waste dumps from a coal mine "did not [have] * * * any rights to * * * the natural deposits of the coal," and added, "refuse banks * * * are not a natural mineral deposit." See *Turkey Run Fuels* v. *United States*, 243 F. 2d 147, 149-150; and see pp. 152, 154 (dissent) (C.A. 3d).

The most recent case to hold that tailings and dumps are not natural deposits is *Soil Builders, Inc.* v. *United States*, 277 F. 2d 570 (C.A. 5th). The mining processes engaged in there were quite similar to those in this case. There, the original mining process consisted of digging hard rock phosphate from the ground and tumbling and washing it over a screen to remove unwanted matter. The material which passed through the screen, sand, clay and small colloidal phosphate particles, was discharged into the graund or into streams. The colloidal phosphate settled from a quarter to a half a mile from the mining activity. Some years later, it was found that the accumulated colloidal phosphate had commercial value. It was mined and depletion claimed. The court held that the water-deposited colloidal phosphate was not a natural deposit. It said (p. 573):

> The colloidal phosphate not only is not in its natural location; it is not even in its natural state. In effect, it is a refined product, refined

> by the removal from it of all sand (silica oxide) and non-phosphate clay. The refinement process and the removal process were one and the same. By this process a deposit was undoubtedly made, but it was not a natural deposit; it was man-made.

These several cases outline the tests for determining whether a mineral deposit comes within the term "mines and other natural deposits." In sum, the *Atlas Milling* case first indicated that a natural deposit did not include a tailings dump deposited on the surface of the land resulting from a residue of ore that had been severed and milled. This Court's *Consolidated* case added that "other natural deposits" cannot be made by man rather than by nature. Later, in its *Hoban* opinion, in the excerpts quoted above, this Court reaffirmed these rules. *Chicago Mines* said the deposit could not be artificially created or result from prior mining. Finally, the *Soil Builders* case pointed out that the material must be in its natural location, in its natural state and unrefined by the removal of any minerals.

The taxpayer's aggregates deposits do not fit the judicial definitions of "other natural deposits." The deposits remaining after the dredge had worked the property were customarily called tailings piles. (R. 66, 114, 117.) The dredging process severed the nature-deposited gold-bearing aggregates from the ground and separated the sand and gold from the gravel and cobbles. The gold was removed from the sand and the sand, gravel and cobbles thus refined were deposited by the dredger on the surface of the

land. (R. 87-89, 96-100.) The material, when deposited, was not in its natural location. Not only had it been moved about 200 to 350 feet from where it had been deposited in nature, but the various components of the aggregates were not deposited together. That is, while any one of the scoops on the forward ladder arm might dig a cubic yard of sand, gravel, cobbles and free gold in varying quantities, the sand was discharged at the end of the barge into the pond, some 225 feet from where it had been dug while the gravel and cobbles were simultaneously deposited at the end of the stacking ladder about 300 to 350 feet from where they were dug. The gold, of course, was not replaced on the surface at all. (R. 64, 66, 87-92, 97-100.) Nor were the aggregates deposited in their natural state. In place as a natural alluvial deposit, the aggregates were intermingled with sand, gravel and free gold filling the voids between the cobbles. Over the layer of aggregates was an over-burden of topsoil and vegetation. The dredge deposited sand and soil (intermingled as they had not been in nature) in a layer on top of bedrock; gravel and cobbles were then dropped in a separate layer on top of the sand without fine particles filling the voids between the larger ones: there was no gold present; and the depth of the aggregate above bedrock had been increased by about 40 percent. (R. 63-66, 89-90, 96-100, 118.) A further indication of the artificial nature of the post-dredging aggregate deposits on the properties the taxpayer worked is the testimony as to the differing processing which the taxpayer was required to undertake with natural

materials and the dredged materials. (R. 130-131, 134.) Under the tests established by the decisions, contrary to the holding of the Tax Court, the taxpayer's aggregates were artificial deposits resulting from prior mining and not "other natural deposits." *Atlas Milling Co.* v. *Jones*, *supra; Consolidated Chollar G. & S. M. Co.* v. *Commissioner*, *supra; Hoban* v. *Viley*, *supra; Chicago Mines Co.* v. *Commissioner*, *supra; Kohinoor Coal Co.* v. *Commissioner*, *supra; Soil Builders, Inc.* v. *United States*, *supra.*

The Tax Court believed this case to be indistinguishable from *Pacific Cement & Aggregates, Inc.* v. *Commissioner*, 31 T.C. 136. We respectfully submit this analysis is incorrect. We have pointed out above the elements which courts, including this one, have found to indicate that a deposit is not a natural deposit. It is on precisely the most important of those points that this case differs from *Pacific Cement.* Thus, as indicated above, the dredger droppings were customarily called tailings piles. The *Atlas* case said tailings were not a natural deposit. In *Pacific Cement*, however, there is no indication of what the dredger tailings were. In fact, in *Pacific Cement* the *Atlas* case was distinguished on the ground that in *Atlas* (31 T.C., p. 139) "there actually were tailings." See *Hoban* v. *Viley*, *supra.* Further, while here the evidence shows that the dredger dug the alluvium, and transported selected portions of it over 300 feet, in *Pacific Cement* the dredge was about 100 feet long and the material dredged was dumped into the pond (31 T.C., p. 140) "in substantially the same place where it had picked it up." Finally, unlike this

case, in *Pacific Cement* there was no showing that the aggregates were deposited separately, in different locations and in different stratification than they occurred in nature. On the contrary, the *Pacific Cement* opinion states that while gravel and sand were separated on the dredge, after the gold was extracted (p. 138), "the gravel and sand were then intermingled and dumped back into the pond." Cf. *Soil Builders, Inc.* v. *United States*, *supra*. Quite apart from the correctness of the *Pacific Cement* opinion, we submit that it cannot be said here, as it was there, that when the dredging was completed (31 T.C., p. 141), "they were the identical aggregates which existed when the process had been commenced." Here, they were not. Therefore, they could not be "other natural deposits."

C. ***The taxpayer's aggregates were "waste or residue of prior mining" as that term is used in Section 613.***

The taxpayer's aggregates were "waste or residue of prior mining" as that term is used in Sections 611 and 613. Although that phrase did not appear in the 1939 Code, courts had occasion to consider what constituted waste and residue in developing a definition of the term "mines and other natural resources." Thus, in *Atlas Milling Co.* v. *Jones*, *supra*, the court indicated that tailings from mineral production were residue. In *Chicago Mines Co.* v. *Commissioner*, *supra*, the court described tailings as waste material. In *Commissioner* v. *Kennedy Min. & M. Co.*, 125 F. 2d 399, 400, note 2, this Court described tailings as ores

which had previously been worked. See also *Hoban* v. *Viley*, *supra*. In addition, in *Kohinoor Coal Co.* v. *Commissioner*, supra, the court said that a waste dump was material (p. 881) "thrown aside" by prior mining operations.

When the three properties here were dredged for gold, the gold alone was extracted and the remaining aggregates were both residue [9] and waste [10] of the gold mining operation. As we have pointed out above, the aggregates discharged after having been worked by the dredger were customarily called tailings, the generic term for waste or residue from mining activities.[11] This Court's *Consolidated* opinion held that the mere severance and piling of ore-bearing rock, without the extraction of a mineral, was sufficient to make the mine tailings residue. Here, the case is stronger because the alluvium deposits were not only severed from their natural state and location, but gold was extracted from the ore-bearing aggregates.

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[9] Webster's New Collegiate Dictionary (2d ed.) defines "residue" as:

> 1. That which remains after a part is taken, separated or designated; remnant, remainder.

[10] Webster's New Collegiate Dictionary, *supra*, defines "waste" as that which is—

> Thrown away as worthless after being used or spent;

[11] Webster's New Collegiate Dictionary, *supra*, defines "tailings" as:

> 1. Refuse material separated as residue in the preparation of various products, as in * * * treating ores.

Although the Tax Court did not independently characterize the *taxpayer's* aggregates as not being "waste or residue", it quoted extensively from its earlier opinion in *Pacific Cement & Aggregates, Inc.* v. *Commissioner*, *supra*, which stated that in that case (p. 140) "there is nothing that resembles a dump or residue." In *Pacific Cement* the Tax Court reasoned that the dredger tailings could not be residue because there had been no prior mining of the property for aggregates. This represents an erroneous view of the law. The Court of Appeals decisions cited above did not develop a concept of waste or residue in relation to activity in extracting a *particular mineral.* Instead, they held that waste or residue was the unwanted by-product of prior mineral production.

The Tax Court's *Pacific Cement* case, in holding that the dredger droppings there were not waste or residue because they had never been mined for aggregates, is directly in conflict with the same court's earlier decision in *Consolidated Chollar Gould & Savage Mining Co.* v. *Commissioner*, 46 B.T.A. 241, affirmed, 133 F. 2d 440 (C.A. 9th). In its opinion in *Consolidated*, the Board rejected (p. 245) as "immaterial" the taxpayer's argument that an ore dump was a mine (and thus a natural deposit) because the dump had never been worked for the kind of ore which was extracted from it by the mining operation in question. We submit that the *Consolidated* reasoning is correct. Clearly, whether a deposit is waste or residue is to be determined in relation to the *previous* mining activity, not in relation to the

current activity alone as the Tax Court held in *Pacific Cement*. For the same reason, it is not necessary that the past and present mining activities be the same.

The 1954 Code makes apparent that whether or not a given deposit has been previously mined for the type of mineral being mined is *not* material to the question of whether the deposit is waste or residue, since the Code makes no such distinction. On the contrary, it speaks of "waste or residue of *prior* mining" (emphasis added) without limitation as to the mineral produced by either the prior or current extraction processes. Section 613(c)(3). The Committee Reports relating to Sections 611 and 613 of the 1954 Code also contain no intimation that any distinction exists as to waste or residue in relation to continuity of the production of a specific kind of mineral. See, e.g., S. Rep. No. 1622, 83d Cong., 2d Sess., p. 329 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4970).

D. ***The taxpayer is a "purchaser of * * * waste or residue or of the rights to extract * * * minerals therefrom" and as such is specifically disqualified under Section 613 from the depletion deduction it seeks***

1. As noted, the 1954 Code makes specific provision for "deposits of waste or residue" from prior mining. Sections 611(a) and 613(c). The purpose of this provision is to "extend percentage depletion at the appropriate rates to mine owners for minerals recovered from the residue that had accumulated from their mine * * * to encourage the production of minerals from these accumulations as well as from the mine it-

self." H. Rep. No. 1337, 83d Cong., 2d Sess., p. 59 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4085). "The effect" of the change is to extend depletion "to the extraction of ores or minerals from waste or residue of prior mining" on the theory that a waste pile is a "part of the property from which it was extracted." *Id.* p. A 183 (3 U.S.C. Cong. & Adm. News (1954) 4322-4323).

The Code carries out this purpose by a series of involuted definitions under which (1) mining includes the extraction of minerals from the waste or residue of prior mining (2) except as to any such extraction of the mineral or ore "by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." [12] This effectively limits percentage de-

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[12] Section 611(a) allows a deduction for depletion "In the case of mines, * * * other natural deposits and timber." The section defines the term "mines," for purposes of the depletion deduction as "includ[ing] deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c)." Section 613(c)(2) defines what is treated as mining to include "the extraction of the ores or minerals from the ground." That phrase is in turn defined by Section 613(c)(3). The first sentence or subsection (c)(3) says that the phrase "extraction of the ores or minerals from the ground" includes the "extraction by mine owners * * * of * * * minerals from the waste or residue of prior mining." The second sentence of subsection (c)(3), however, says that inclusion of "waste or residue" in the phrase "extraction of the ores or minerals from the ground" (which is accomplished by the first sentence) "shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom." Thus, if the taxpayer *is* a purchaser of waste or residue, the extraction of such waste or residue, by definition, is not treated as mining in Section

pletion on minerals extracted from waste or residue to the owner or operator who, in mining, created the waste or residue. As to such a party, the waste or residue is considered a part of the mine and the extraction of mineral therefrom a continuation of the original mining activity. But the situation is different as to other parties, whether they purchase the waste or residue directly or only "the rights to extract ores or minerals" from the waste or residue. Thus, even a lessee is not entitled to percentage depletion on the mineral extracted from waste or residue.

The natural construction of the statutory language is in accord with the Congressional intent already mentioned and, moreover, the legislative reports further emphasize the contrast between the original miner and any other party, referred to as a purchaser. H. Rep. No. 1337, *supra*, p. A 186 (3 U.S.C. Cong. & Adm. News (1954) 4325) explains: "No depletion allowance shall be permitted * * * in respect of the working of waste or residue by a person other than the mine owner or operator, such as the purchaser of the waste or residue or of the rights to extract ores or minerals therefrom." See also S. Rep. No. 1622, *supra*, pp. 79, 333 (3 U.S.C. Cong. & Adm. News (1954) 4712, 4973-4974). The Reports further explain, "Thus where a mine owner is engaged in the mining and sale of ores or minerals * * * produced by him from waste * * * [from the original mine

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613(c), and therefore the deposits of such waste or residue are not "mines" within the definition of that word in Section 611(a) and so are not deposits which are subject to depletion within the Code.

workings], the gross income from" the waste forms a part of the gross income from the property. S. Rep. No. 1622, *supra*, p. 329 (3 U.S.C. Cong. & Adm. News (1954) 4970). But "this provision is not applicable to any such extraction of the mineral or ore by the purchaser * * * [and] the term 'purchaser' includes a person who acquires such waste or residue in a taxable transaction." S. Rep. No. 1622, *supra*, p. 333 (3 U.S.C. Cong. & Adm. News, supra, pp. 4973-4974).

Thus, percentage depletion is permitted in relation to waste and residue only when the mining is done by the owner or operator who originally mined the property (except for tax-free successors in interest)[13] on the theory that the mining of tailings and waste is but a continuation and completion of the original mining process. See *Kohinoor* v. *Commissioner*, *supra;* Treasury Regulations on Income Tax (1954 Code), Section 1.613-3(f).

2. There can be no doubt that the taxpayer was a purchaser either of the waste or residue as such or of the rights to extract ores or minerals therefrom. Whether the agreements involved here were sales contracts or leases is immaterial. It is sufficient that the taxpayer was a "purchaser" within the meaning of the statute.

The agreement under which it operated the Featherston property recited (R. 34-35):

> Whereas, as a result of the dredging operations by * * * [the dredging company], sand and

[13] See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 331 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4973-4974).

> gravel have been made available, which sand and gravel * * * [the taxpayer] desires to purchase to the extent herein described.
>
> * * * *
>
> 2. * * * [the taxpayer] agrees to pay annually to * * * [the dredging company] for a minimum of 100,000 tons of said sand and gravel, whether or not said sand and gravel are actually mined or removed.

The taxpayer operated on the Putnam Ranch under two agreements. The first, entitled (R. 39) "Option to Purchase Gravel," provided in part (R. 39-40)—

> L. E. Putnam and Edna Putnam Albertson * * * agree to give to * * * [the taxpayer] an Exclusive option to purchase sand, gravel and rock from the Dredger operations on the property * * *.
>
> * * * *
>
> Payment for materials to be made monthly based upon the quantities removed by the * * * [taxpayer].

The second agreement on the Putnam Ranch provided, in part (R. 41-42)—

> the parties hereto are desirous of continuing * * * [the first] agreement and making certain modifications thereof;
>
> * * * *
>
> 1. * * * that * * * [the taxpayer] has purchased concrete aggregate material situate on adjoining properties; * * * the * * * [Putnams] shall receive from [the taxpayer] the cash sum to be in full and final payment for all royalties

> to which * * * [the Putnams] would otherwise be entitled for concrete aggregates excavated * * *.
>
> * * * *
>
> 3. * * * [the taxpayer] shall continue to pay for such materials so removed the maximum amount provided for in the [first] agreement * * * or a minimum sum of $1,000.00 per year, whichever amount is greater * * *.

The taxpayer operated on the Wright property under an agreement entitled an "Agreement of Sale" which provided, in part (R. 43-44)—

> This agreement of sale is * * * entered into * * * between Percy F. Wright and Natalie R. Wright, his wife, (hereinafter termed The Vendors) * * * and Claude C. Wood Company, (hereinafter termed The Purchaser) * * *
>
> Whereas, The Vendors now own * * * land * * * on which land, in years past, mining operations have been conducted, and
>
> Whereas, as a result of said mining operations, there is now present on the surface of this land a quantity of rock, gravel, sand and dredger tailings, and
>
> * * * *
>
> Now, Therefore, the Vendors and the Purchaser make and enter into this agreement of sale of the said rock, gravel, sand and dredger tailings * * *.

Thus, it appears that this taxpayer is a "purchaser * * * of "waste or residue or of the rights to extract ores or minerals therefrom" as that term is used in

Section 613(c)(3). The taxpayer did not own the three properties and it did not do the "prior mining" for gold which resulted in the original displacement of the rock, sand and gravel. It is, therefore, a party to whom the expanded definition of "mines" (and, inferentially, "natural deposits") does not apply and so it cannot deduct percentage depletion on "waste and residue" under Sections 611 and 613. The Tax Court erred in holding that it was entitled to the depletion deduction.

E. *The Tax Court's finding that the aggregates were natural deposits is not binding on this Court*

The Tax Court found, purportedly as a fact (R. 67), that "The aggregates taken from the Putnam, Wright and Featherston properties in the year in question were natural deposits that were mined by petitioner." We point out, however, that this is not a case where the Court's scope of review is limited to determining whether a finding is supported by the evidence. Such a factual inquiry arises only where the trial court has applied the proper legal standard established by the statute (*United States* v. *Wagner Quarries Co.*, 260 F. 2d 907 (C.A. 6th), as this Court has often recognized (see, e.g., *Riddell* v. *Victorville Lime Rock Co.*, 292 F. 2d 427; *Riddell* v. *California Portland Cement Co.*, 297 F. 2d 345).

Here the Tax Court plainly failed to apply the proper legal standard, and therefore erred as a matter of law. In the first place, the Tax Court did not apply the proper test of "natural deposits"—as evidenced by the numerous cases in point we discussed

earlier. Secondly, there is no direct indication that the Tax Court considered the statutory provisions relating to waste and residue and their concomitant limitation in relation to purchasers thereof or of rights in respect thereof. Assuming that it did and nevertheless held that the taxpayer is entitled to a percentage depletion allowance on the ground that the aggregates were natural deposits rather than waste or residue, the court compounded its error with respect to the meaning of "natural deposits" by failing to recognize and apply the legislative intent with respect to the waste or residue of prior mining.

Under the circumstances, the Tax Court's finding that the aggregates were natural deposits does not confine the issue to a factual inquiry. Indeed, there is no conflict in the evidence; the only question is whether the Tax Court correctly applied the law to the facts. The Tax Court's finding that the aggregates were natural deposits would, we believe, be clearly erroneous even if viewed from a purely factual standpoint.

CONCLUSION

For the reasons stated, the decision of the Tax Court is incorrect and should be reversed.

Respectfully submitted,

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MARCH, 1963.

CERTIFICATE OF SERVICE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:.....day of....., 1963.

Attorney

APPENDIX A

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

(26 U.S.C. 1958 ed., Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an

amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * *

(c) *Definition of Gross Income from Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) *Extraction of the ores or minerals from the ground.*—The term "extraction of

the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

* * * *

(26 U.S.C. 1958 ed., Sec. 613.)

APPENDIX B

SCHEDULE OF EXHIBITS IDENTIFIED, OFFERED, AND RECEIVED IN EVIDENCE:

Exhibit	Description	Identified Record Page	Offered Record Page	Received Record Page
Joint				
1-A	Tax Return	19	81	81
2-B	Articles of Incorporation	19	81	81
3-C	Purchase Agreement	19	81	81
4-D	Option to Purchase	20	81	81
5-E	Purchase Agreement	20	81	81
6-F	Agreement of Sale	20	81	81
7-G	Schedule	21	81	81
8-H	Photograph	51	81	81
9-I	Diagram	51	81	81
10-J	Schedule	51	81	81
11-K	Schedule	51	81	81
Petitioner's				
12	Photograph	123	124	124

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No. 18,226.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT.

MORTON K. LANGE,
Appellant, Cross-Appellee,

vs.

LIBERTY NATIONAL INSURANCE COMPANY,
Appellee, Cross-Appellant.

Appeal from the United States District Court for the District of Idaho, Northern Division.

APPELLANT'S REPLY BRIEF.
CROSS-APPELLEE'S BRIEF ON CROSS-APPEAL.

THOMAS A. MITCHELL,
Attorney for Appellant.

St. Louis Law Printing Co., Inc., 415 N. Eighth Street. CEntral 1-4477.

INDEX TO APPELLANT'S REPLY BRIEF.

Cases Cited.

Statutes Cited.

Textbooks Cited.

INDEX TO CROSS-APPELLEE'S BRIEF ON CROSS-APPEAL.

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APPELLANT'S REPLY BRIEF.

I.

The December 10, 1956, resolution contemplated the complete refinancing of the company, and restoring it to a condition of solvency, and successful operation, with a multiple line license, and it was so explained to plaintiff (Tr. p. 44).

Plaintiff subscribed to the stock under a **written** agreement which provided that the money would be held by the Trustee until sufficient funds had been subscribed to accomplish that result. The **subscription** alone did not authorize the taking of the money into the Treasury, unless it was sufficient to provide the minimum capital **and** to permit the continued operation.*** Nor did it relieve the Commissioner of his responsibility to be able to guarantee this before he accepted it.

*** Where possible, a reasonable and equitable interpretation will be given a contract, and not one which will give one party an unfair advantage. An absurd result will be avoided. 17 C. J. S. 739. Plaintiff's correspondence shows that this was not his understanding. See Exh. 21, Exh. 23 and Exh. 27.

By accepting the money into the Treasury, the Rehabilitator impliedly represented and "guaranteed" that it was sufficient for both purposes above mentioned.* Mr. Albertson's failure to file the evidence necessary for the joint control order, plus his correspondence,** plus his testimony at the trial show that it was sufficient for neither. His testimony, and defendant's brief (p. 20), admit that he would not have been able to "absolutely promise" that the assets and liabilities were in balance at year end until a "couple of months" later, and until the claims had run off (Tr. p. 330). A "couple of months" later, when he could tell, the policy holders surplus had decreased over $100,000. This, however, the defendant concealed from the plaintiff for over a year and one-half.***

There is no present contention, and there was no testimony that plaintiff was a party to any agreement or any discussion which modified the agreement **after it was signed**,† or that the minds of the parties met on a definite modification.†† There is no contention and there was no testimony that there was a modification of the agreement to permit the acceptance of the money unless all

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* To promise is to "guarantee". Manuel v. Calestagas Vinyard Co., 61 Pac. (2) 1204; Wright v. Barnard, 248 Fed. 256; McClune v. Central Trust Co., 165 N. Y. 10, 58 N. E. 777, 26 C. J. S. 1069. He expressly represented that it was sufficient to permit the company to operate **"during the year 1957"** by sending plaintiff a copy of Exh. 18.

** Exhibits 19, 21, 22, 53, 55, 56, 59.

*** Where one who has made a misstatement remains silent after he has learned of his error, he is both morally and legally in the same position as if he had known when his statement was made that it was erroneous. Chelson v. Houston, 84 N. W. 354, 9 N. D. 498; Maxwell Ice Co. v. Brockett, 116 Atl. 34, 80 N. H. 236; Hush v. Reaugh, 23 Fed. Supp. 646.

† Although the agreement is dated December 11, 1956, it was stipulated that it was signed on January 11, 1957 (P. T. O., p. 19).

†† Kell v. Gross, 171 Fed. (2) 715. A modification must be shown by clear and convincing evidence. Utley v. Donaldson, 94 U. S. 29, 24 L. Ed. 54, and will not be inferred from conduct of doubtful significance. Motor Parts Co. v. Bendix Home Appliances, 36 Fed. Sup. 649 (Cal.). The burden of proof to establish a modification is on the party asserting it. The Jobshaven, 270 Fed. 60.

of the above mentioned conditions were met. Nor is there any present contention that there was a modification of either of the conditions subsequent to return the money to the subscribers if sufficient funds were not raised by March 15 to permit continued operations, or to return the balance of the shares unsold to the treasury for cancellation upon acceptance of the money subscribed or of the agreement for joint control.

Although each one of the conditions above mentioned was a material part of the stock subscription agreement, not a single one of them was complied with. Therefore, even if the agreement was modified, it was not modified in any manner which would have affected the matters plaintiff now complains of. Whatever this alleged modification consisted of—and we confess that we cannot tell from defendants evidence what this was—it was wholly immaterial to this lawsuit.

Defendant says that the modification was necessary to provide the minimum capital for the defendant to continue in business after December 31, 1956, in order to avoid liquidation. The answer to that is that the funds subscribed did not provide the minimum unimpaired capital, in any event, except on paper.

Furthermore, the evidence does not sustain defendant's contention that this was the real reason for taking the money at that time. It was not required under Idaho law in order to avoid liquidation.*

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* Sect. 41-3504 of the Idaho Code contemplates Rehabilitation even during insolvency. The commissioner has broad discretion whether to liquidate or rehabilitate. Matter of National Surety Co., 239 App. Div. 490, 268 N. Y. S. 88; Matter of Globe and Rutgers Fire Ins. Co., 149 Misc. 18, 266 N. Y. S. 603. On this point plaintiff testified as follows (Tr. p. 194):

> Q. "You knew that the money had to go into the treasury very shortly after Dec. 31st or liquidation would follow"?
>
> A. "No, I didn't know that. The thing changed from time to time a little bit. He first said it would have to be by January 31. Later he changed it and said that the deadline could be extended to March 15 to be reflected back to the Dec. 31 financial statement".

The real requirement to avoid liquidation was the urgent need to obtain money to pay claims. The evidence however falls short of showing that plaintiff was advised of this urgency. He denied that he was.***

Defendants real contention is that since plaintiff was anxious to avoid liquidation, and since it was necessary to use the money to pay claims to avoid liquidation, plaintiff impliedly agreed to the use of the money for that purpose, regardless of all of the other conditions of the agreement. This argument confuses plaintiffs motive with the actual consideration for the stock subscription.*

Concededly, plaintiff wanted to avoid defendant's liquidation. He knew the financing was minimal and that further financing was needed to permit "successful operations". However this was a conditional **subscription,** not a direct sale, and the payment was made to a trustee to be held until the conditions were complied with. It does not follow that plaintiff would have agreed to subscribe to this stock under a plan that was less than minimal, which would have permitted the acceptance of the money to pay claims, and merely postpone the liquidation for two months.

Defendant admits that even under its modification theory the funds subscribed were to have been returned to the subscribers if sufficient subscriptions were not obtained by March 15 to permit the continued operation of the

*** Mr. Dolan and Mr. Albertson testified that there was a cash shortage to pay claims. Neither testified that he or any one else advised plaintiff thereof. Mr. Dolan testified that it was common knowledge, and that "he was sure" plaintiff was aware of it. See Union Pacific Ry. Co. v. O'Brien, 16 Sup. Ct. 618, 161 U. S. 451, a witness cannot say what other witnesses are aware of. This is mere opinion, and cannot be considered substantial evidence even when uncontradicted. Otis v. S. E. C., 176 Fed. (2) 34, Wichita Falls Ry. Co. v. Holbrook, 50 S. W. (2) 428. Mr. Albertson's first direct mention to plaintiff of a shortage of cash (Ex. 53) advised that this is to be expected, not this was to be expected. This implies that plaintiff was not informed of it before hand.

* Williston, Contracts, Sect. 111; Williston, Contracts, Sects. 860, 1292; Klein v. Zeeve, 92 Pac. (2) 877, 1 C. J. S. 1318.

company. The money therefore should have been held in trust until March 15, and returned immediately thereafter, when it appeared that sufficient subscriptions had not been obtained.† The spending of this money as well as the accepting of it was, therefore, a conversion.*

The Court's findings that the money was turned over to the defendant "absolutely", ignored the fact that, if so, plaintiff, under the agreement, thereby and thereupon became a stockholder in the defendant,** also that under the agreement, the balance of the shares of stock were in the hands of the Commissioner for one purpose only, namely to be returned to the Treasury for cancellation, and the sale thereof to the Becker-Rummel group was a direct violation thereof, and absolutely void.***

This very flagrant violation of the escrow agreement was established by undisputed, **stipulated** evidence (P. T. O. p. 5).**** It was completely ignored by the trial Court in his findings, and is dismissed by the defendant's brief (p. 23) in this Court with a flippant remark.

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† Hulen v. Stuart, 191 Cal. 562, 217 Pac. 750; Wann v. Diablo Finance Corp., 23 Pac. (2) 303, 132 C. A. 621.

* Grocers, Inc. v. Horstmann, 46 N. W. (2) 254, 233 Minn. 192; Firsthamel v. Campbell, 55 Cal. App. 774, 205 Pac. 25; National Bank of the Republic v. Price, 234 Pac. 231; Cobbin v. Conklin, 208 Fed. 231; Robertson v. 1st National Bank, 35 Ida. 363, 206 Pac. 689; Barnett v. Williams, 168 So. 583; Porter v. Beha, 8 Fed. (2) 65, affmd. 12 Fed. (2) 513; Lucas v. Central Missouri Trust Co., 166 S. W. (2) 1053, 350 Mo. 593; Petroleum Royalties Co. v. Hartford Accident and Indemnity Co., 106 Fed. (2) 440, 124 A. L. R. 1403. Mason v. Lievre, 145 Cal. 582, 78 Pac. 1040; Majors v. Girdner, 159 Pac. 826.

** As of that moment, title passed, and plaintiff became the owner of 6,452 shares out of 21,522 outstanding shares, or of an approximate ⅓ interest, Mitchell v. Beekmen, 28 Pac. 110, 64 Cal. 117; Young v. Pedrara Onyx Co., 192 Pac. 55.

*** Williston on Sales, Section 311. It is a fundamental doctrine of the law of sales that no one can give what he has not. If the money was accepted absolutely, the old stockholders' share in the company was fixed at 2,162 shares, or a 10% interest in the whole. They no longer owned 38,377 shares to which they could transfer title. Young v. Pedrara Onyx Co., supra; Hulen v. Stuart, supra; Wann v. Diablo Finance Corp., supra.

**** Lumbermens Trust Co. v. Town of Rygate, 61 Fed. (2) 14 (C. C. A. 9); Home Indemnity Co. v. Standard Accident Ins. Co., 167 Fed. (2) 919.

As the owner of an approximate one third interest in the defendant company, plaintiff acquired certain rights to a proportionate voice in determining to **whom** such shares should be sold, and a proportionate voice in the selection of Directors, who would carry out the policies which he favored,* and a proportionate voice in whatever further refinancing the Commissioner required.

The defendant treated the entire proceeding under the December 10, 1956, resolution as void, because the plan was not completed by March 15, 1957. Having so treated it, the defendant cannot now treat it as having been effective as to plaintiff, but void as to itself.**

None of the defendant's so-called defenses are applicable to this cause of action.

Plaintiff's specific refusal to sign a waiver and consent to the sale of this stock until the defendant would get behind the Agency and carry out its commitments, was an affirmative indication of an intention **not** to waive his rights to rescission. It was equivalent to a reservation of rights.†

II.

(1) Plaintiff does not predicate a charge of fraud upon the broken promise alone to provide Green Cards, excess limits, and expanded coverage. He predicates a charge of breach of a collateral agreement which was a substantial part of the consideration for the stock subscription agreement, which breach justified rescission.†† The charge

* In Re National Lock Company, 9 Fed. Supp. 432; Campbell v. Coin Machine Mfg. Co., 188 Pac. 197, 96 Oregon 119; McArthur v. Port of Havana, 247 Fed. 984.

** When a person accepts the benefits of a new contract, he cannot maintain that the old contract was in effect. 31 C. J. S. 351; Richardson v. Heslap, 293 Pac. 168, 109 Cal. App. 440; Menton v. Mitchell, 265 Pac. 271; Penn Mutual Life Insurance Co. v. Bank of America Trust and Savings Association, 54 Pac. (2) 453, 5 Cal. (2) 288.

† Woods v. Markwell, 258 Pac. (2) 503.

†† Carlton v. St. Vincent Seed Co., 129 Cal. App. 222, 18 Pac. (2) 407; Meeks v. Commonwealth Bonding Co., 187 S. W. 681.

of fraud is predicated on the making of the promises with intention not to perform. The evidence in support of this charge consisted not only of the promises, and the failure to perform, but also the inconsequential time lapse between the making of the promise and the refusal to perform; the lack of the pretense at performance, and subsequent conduct and speech showing no intention to perform while, leading plaintiff to believe performaance was forthcoming.**

Defendant's argument that the Agency had Green Cards most of the time, overlooks the fact that the arrangements for Green Cards with the Fortune Insurance Company were bogus arrangements, were recognized by the defendant as such,*** and that it made repeated promises before, during and after the Rehabilitation to obtain legitimate ones.

The argument that the obtaining of Green Cards was beyond the defendant's control admits that defendant was unable to get them. Impossibility of performance is not a defense to an action for rescission grounded upon breach of contract.*

(2) Plaintiff was entitled to rely upon Mr. Albertson and Mr. Chapman.† Plaintiff testified that he did rely upon representations made by Mr. Albertson and Mr. Chapman.†† There was no evidence that he did not. Aside

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** Pocatello Security Trust Co. v. Henry, 35 Idaho 821, 206 Pac. 175, 29 A. L. R. 347; McLean v. Southwestern Casualty Ins. Co., 61 Oklahoma 79, 159 Pac. 660.

*** The use of these bogus Green Cards by the defendant was a violation of the principal's duty to protect the agents' reputation. Restatement, Agency, 437.

* Fish v. Valley Bank of Phoenix, 167 Pac. (2) 107; Bridges v. Ingram, 223 Pac. (2) 1051.

† In Detroit Fire and Marine Insurance Co. v. Sargent, 42 Idaho 369, 246 Pac. 311; Watson v. Holden, 79 Pac. 503, 10 Ida.

†† Plaintiff testified (Tr. pp. 165, 166) that he had no knowledge of the company except for what he was told; that he was told and understood that Mr. Albertson had made an audit of the company; that Mr. Albertson had the "know-how" that he, plaintiff, did not have, and he relied on Mr. Albertson and Mr. Chapman's statements.

from his own evidence he was entitled under the facts of this case to a presumption that it was intended that he should rely on them*** and that he did rely upon them.*****

The other factors or motives may have influenced plaintiff's subscription or that the misrepresentations were not the sole or predominating force, is immaterial.**** Defendant completely ignores that its false 1954 financial statement was the original inspiration for plaintiff's motive to save the company from liquidation.

(3) The representations admittedly (Tr. p. 327) made to plaintiff were all statements of fact, not opinion, within the meaning of the law of fraud.*

These statements are actionable even though Mr. Chapman and Mr. Albertson believed them to be true at the time they were made. It is sufficient that they made them without knowing them to be true.** Mr. Chapman, as Vice

*** Defendant's intention to induce plaintiff to action and to alter his position can be inferred from the fact that representations were made with knowledge that plaintiff could act upon reliance of them. Gagner v. Bertram, 275 Pac. (2) 15, 48 C. (2) 481; Nathanson v. Murphy, 282 Pac. (2) 174, 132 Cal. App. (2) 363.

***** Where representations have been made in regard to a material matter, and action has been taken, it will be presumed that the representations were relied upon, in the absence of evidence showing the contrary. Williston, Contracts, Section 1516.

**** McDonald v. DeFremery, supra; Sheffer v. Rednech, 196 N. E. 864, 291 Mass. 205; Light v. Jacobs, 183 Mass. 206, 66 N. E. 799; Williston, Contracts, 3rd Edition, Section 1515; Buck v. Leech, 69 Maine 484; McGrath v. Ct. Scherer Co., 195 N. E. 919, 37 C. J. S. 539; 37 C. J. S. 26.

* Representations that a company is solvent, or with reference to the condition of its business, or as to its previous earnings, that it is not indebted at all, or is only indebted to a certain extent, may constitute actionable fraud, even though the person making them believed them to be true. 12 Fletcher, Corporation, 5583. Examples of similar representations may be found in Leary v. Baker, 258 Pac. (2) 1090 (1953); Burckhardt v. Woods, 12 Pac. (2) 482; Goodin v. Palace Store Co., 4 Pac. (2) 493; Guaranty Mortgage Co. v. Ellison, 239 Pac. 29, Utah (1925); Nevada Bank v. San Francisco and Portland National Bank, 59 Fed. 338. The representation that Mr. Albertson had made an audit of the company (Tr. p. 276) was itself a representation. Guaranty Mortgage Co. v. Ellison, 239 Pac. 29 (Utah 1925).

** Wietzel v. Jukich, 73 Idaho 301, 251 Pac. (2) 542; Turner v. Pemberton, 221 Pac. 133, 38 Idaho 235.

President, and Mr. Albertson, who advised plaintiff that he had made an audit (Tr. pp. 165, 166, Ex. 10), had means of information not open to plaintiff, and the parties were not dealing on equal terms. Under these circumstances, even a matter of opinion may amount to an affirmation of fact and should have been construed as a representation that they knew facts which justified the opinion.*** The evidence clearly showed that the representations were false; that as to Mr. Chapman they were known to be false,* and as to Mr. Albertson that they were at least made recklessly without knowledge of their truth, and were, therefore, not honestly believed.**

Although concededly, Mr. Albertson had nothing to do with the actual sale of this stock, and did not profit thereby, his own evidence (Tr. p. 327) shows that he made the representations which were calculated to and did induce action on the part of the plaintiff (Tr. p. 165); and that he obtained his information from the defendant's officers and employees (Tr. p. 343).† The rule that a corporation is liable for the fraud of a receiver†† should certainly apply in this case where the fraud was due to false infor-

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*** Downs v. National Share Corp., 55 Pac. (2) 27 (Ore.); Fletcher, Corporation, 5591; Hindman v. First National Bank of Louisville, 112 Fed. 931; Bigelow, Fraud (1890), p. 509. Restatement of the Law of Contracts, Sect. 471: A tells B he has investigated the affairs of company C, and that it is sound financially. He has not investigated C company. His statement is fraudulent even though he believed C company is sound financially.

* Griswold v. Gebbe, 126 Pa. 353, 17 Atl. 673; O. F. Nelson Co. v. United States, 149 Fed. (2) 692 (9th Circuit) (19..); Masterson v. Pig'n Whistle Corp., 326 Pac. (2) 919. Plaintiff is entitled to an inference from the failure to call Mr. Chapman as a witness. Morrow v. Franklin, 233 S. W. 231 (1931); Powell v. Landes, 36 Pac. (2) 462, 95 Colo. 375.

** Hobart v. Hobart Estate Co., 159 Pac. (2) 958, 26 Cal. (2) 412 (1945); McDonald v. DeFremery, 168 Cal. 199, 142 Pac. 73. An expression of opinion to avoid an action for deceit must be an expression of an opinion honestly entertained by the person making it.

† It is immaterial in an action for fraud that the person making the misrepresentations did not intend to benefit himself but solely to benefit a 3rd person. 37 C. J. S. 26. Representations made to a 3rd person to be communicated to plaintiff may be relied upon. 37 C. J. S. 284.

†† Hershberger v. Woodrow Parker Co., 275 Fed. 908.

mation furnished to the receiver. This is true whether the receiver intended to deceive the plaintiff or not. Obviously, the defendant so intended by furnishing the receiver with false information. Schafuss v. Betts, 94 Misc. 463, 157 N. Y. S. 608.

The company ratified Mr. Chapman's misrepresentations, and also his promises to obtain Green Cards and other facilities, by accepting the benefits of the subscription. This is so clear that defendant's brief does not even try to answer it.***** It is also clear that all of the stockholders, who were officers and Directors, specifically ratified both Mr. Chapman's and Mr. Albertson's actions at the meeting of April 15, 1957. The District Court approved Mr. Albertson's approval of the agency contract, when it approved his acts at the termination of the Rehabilitation (Ex. 65).**

(4) Defendant refers to no evidence which indicates that plaintiff did not believe or rely on the representations in question. The defendant repeated the representations to plaintiff and concealed the true facts from him for a year and half. This shows that the plaintiff did believe the representations, that defendant knew he believed them, and wanted him to continue to believe them, until enough time had elapsed for defendant to be able to cry waiver, estoppel, laches and ratification, just as it is doing now.

This argument also overlooks the obvious effectiveness of the Chapman, Albertson, Dolan combination in selling

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***** H. I. Case Co. v. Bird, 11 Pac. (2) 966, 51 Idaho 725; Inter Mountain Ass. of Cattlemen v. Pierce, 43 Idaho 279; Davenport v. Burke, 30 Idaho 599, 167 Pac. 481; Shake v. Fayette Valley Produce Exchange, 42 Idaho 403, 245 Pac. 683; United States v. Carbon County Land Co., 46 Fed. (2) 980.

** Standard Roller Bearing Co. v. Hess Bright Mfg. Co., 275 Fed. 916, C. C. A. 3, 1921; Reinsurance Agency, Inc. v. Liberty National Insurance Co., 307 Fed. (2) 164.

this stock. Obviously, somebody very, very well versed in the art of juggling figures at some time must have convinced Mr. Albertson of the soundness of this company,—and thereby armed it with a very potent weapon.*

III.

Defendant's claim that the plaintiff's claim is barred by res adjudicata is without merit.

There is a vast distinction between this case and the Reinsurance Agency case.*** In that case, this Court specifically ruled that the contract in question was one of the assets of the company taken over by the Rehabilitator, pursuant to the Rehabilitation order. The District Court acquired summary jurisdiction of the Reinsurance Agency by virtue of its jurisdiction over the res.†

In this case, the Court did not, by the appointment of the Rehabilitator, acquire jurisdiction of the stock of the company. The stock does not belong to the company, and is not therefore a part of the "res".** The Rehabilitator obtained custody of the stock, but not title thereto,†† and the sale of the stock under both plans was the act of

* Mr. R. W. Nelson, President, Mr. R. S. Nelson, Secretary, Mr. A. L. Gridley, Mr. Ezra Whitla and Mr. W. C. McNaughton, Directors, all subscribed to stock under the minimum financing plan. Significantly absent from those who availed themselves of this golden opportunity were the two Vice Presidents, Vice President in charge of claims, Mr. Phili Dolan—now President—and Mr. Joseph Chapman. Mr. Chapman did risk about $200 to buy 25 shares of stock—Mr. Dolan not a penny. Exs. 65, 66.

*** Reinsurance Agency, Inc. v. Liberty National Insurance Company, 307 Fed. (2) 164.

† The distinction is clearly shown in Maloney v. Rhode Island Insurance Co., 251 Pac. (2) 1027, 115 C. A. (2) 238 (1953). See also People ex rel. Conway v. Metropolis Insurance Co., 239 N. Y. S. 55, which involved facts almost identical with those in this case.

** Fletcher, Corporations, Ch. 58, Section 5083, p. 41; Clark, Receivers, Sect. 707 a and c, 19 C. J. S. 1209.

†† "Custody" is the charge to keep and care for the property of the owner, subject to his order and directive, without any interest or right therein adverse to him. 25 C. J. S., p. 70.

the stockholders, not of the Rehabilitator.**** His participation in both plans was limited to his approval or disapproval, and even that was not necessarily required.***** This was not a statutory "Rehabilitation Plan", which required the stockholders and the creditors to scale down their interests, and which required court approval to make it binding on the non-assentors. It was purely a voluntary recapitalization plan, accomplished by the adjustment of securities, with the unanimous consent of all of the stockholder members, under which the Insurance Department agreed that the causes and conditions which had made the Rehabilitation necessary, had been removed.**

The proceeds of the sale of stock were subject to all of the rights and conditions attached to the stock subscription agreement, and could become assets of the company only when these conditions had been complied with.*** The Rehabilitator, of course, had no right to take property belonging to a third person, or to a better title than the company had.† The funds in question, therefore, remained trust funds in the hands of the company.*

**** Mr. Albertson was especially careful in his testimony to make this clear (Tr. p. 325 and p. 335). All of the sales contracts and subscription agreements make it very clear (Exhs. 24 and 26).

***** If a plan of reorganization merely contemplates the introduction of new capital, reorganization could proceed even though the commissioner's approval was lacking, unless it was otherwise required. In Re Lawyers Mortgage Co., 169 Misc. 802, 9 N. Y. S. (2) 250, Affmd., 256 App. Div. 974, 11 N. Y. S. (2) 250. If other grounds exist, application for termination will be denied. Matter of Globe and Rutgers Fire Ins. Co., 266 N. Y. S. 603. See also In Re Lawyers Title Co., 165 Misc. 776, 1 N. Y. S. (2) 137.

** Fletcher, Corporations, Sect. 7215; Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482, 57 L. Ed. 931, 33 S. C. 554; Tolman v. Ubero Plantation Co., 142 Fed. 271.

*** Williston, Sales, Sect. 311; Fletcher, Corporations, Sects. 5613, 5479. Hulen v. Stuart, supra; Wann v. Diablo Finance Corp., 23 Pac. (2) 303, 132 C. A. 621.

† Arizona Corp. Commission v. California Ins. Co., 236 Pac. 460, 28 Ariz. 128; Porter v. Beha, 8 Fed. (2) 65, affmd. 12 Fed. (2) 552.

* Maloney v. Rhode Island Insurance Comp., 251 Pac. (2) 1027, 115 C. A. (2) 238 (1953); In Re International Milling Co., 259 N. Y. 77, 181

We are dealing here, not with a stockholder member of the company at the time the reorganization is necessary, who refuses to accept a plan of reorganization and tries to invalidate it, but with an investor non-member of the company, who offers to invest in a reorganization plan subject to certain conditions, but whose investment was accepted on other conditions.** This action is not an action to set aside the reorganization plan itself, but to rescind because of the breach of material conditions upon which plaintiff agreed to participate in it.***

Significantly, it does not appear that Mr. Albertson ever asserted any unconditional claim to the proceeds of the sale of stock under the minimum financing plan. He did not ask the District Court to rule on this question, and the Court did not rule on it.

It can hardly be denied that the plan under the December 10, 1956 resolution was abandoned in toto, shortly after plaintiff left, and the Becker-Rummel plan was subsequently adopted as the actual Rehabilitation plan. Both Mr. Moore and Mr. Dolan so testified (Tr. p. 180 and p. 366), and all of the minutes, documents, and actions of the parties so indicate. The Becker-Rummel group, with full knowledge that they needed plaintiff's consent, agreed to go ahead with the sale with or without it, and subject to his claim for the return of his money.****

N. E. 54; Farrell v. Stoddard, 1 Fed. (2) 802; In Re Lawyers Title and Guarantee Co., 162 Misc. 188, 294 N. Y. S. 381; People v. Metropolis Insurance Co., supra.

** Plaintiff agreed to subscribe on a basis whereby he would receive not less than approximate 1/6 interest. His interest was finally fixed at less than 11%.

*** Farish v. Cienguita Copper Co., 100 Pac. 781, 12 Ariz. 235, where a similar right of action is recognized. This distinguishes this case from Carpenter v. Pacific Mutual Life Insurance Co., 74 Pac. (2) 761.

**** See all of the documents comprising Exhibit 26, including the Opinion of the attorney-general.

With these facts very obviously in mind, and with full knowledge that plaintiff had raised the question of the legality of the stock sale, and while negotiations were in progress (Exhs. 33, 34) the Rehabilitator and the company agreed to permit the lifting of the Rehabilitation order. They thereby, by implication, agreed and represented to the Court that the reserves for outstanding liabilities, which necessarily included plaintiff's claim, were adequate.* By accepting the restoration of its property and the termination of the Rehabilitation proceedings, the company assumed responsibility for plaintiff's claim.** There is nothing in the proceedings for the termination of the Rehabilitation, including the judgment, to indicate that the proceedings were intended to go beyond the issue of the right of the Insurance Department to remain in control of defendants business.*** All of the evidence points to the contrary, including the notice of the hearing itself, which specifically informed plaintiff that "this is not a notice requiring you to appear, but you may do so if you desire" (Exh. 64).****

It appears that the District Court was informed of both Rehabilitation plans***** and was also informed of **facts,**

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* Matter of Globe and Rutgers Fire Ins. Co., supra.

** Texas and Pacific Ry. Co. v. Johnson, 151 U. S. 87, 14 S. C. 250; Clark, Law of Receivers, Sect. 697; Chicago, R. I. & Pac. Ry. Co. v. McBride, 136 Ark. 193, 206 S. W. 149.

*** Caminetti v. Imperial Mutual Life Insurance Co., 129 Pac. (2) 432, 139 Pac. (2) 681 (Same case).

**** Due process requires that a notice inform the opposite party of the nature of the claim. Philadelphia Co. v. S. E. C., 175 Fed. (2) 808.

***** State v. Bank Savings and Life Ins. Co., 75 Pac. (2) 297, 147 Kans. 170. Presumably the court did not approve two plans at the same time, one inconsistent with the other. Jones, Evidence, Sect. 47, 31 C.J.S. 769. Mr. Albertson's affidavit to the Court (Exh. 65) is replete with details concerning immaterial matters, but unusually vague concerning matters of importance. It fails to describe the minimum financing plan, except that it was minimal in nature. He also failed to describe the nature of the "arrangement" which he felt could be made to purchase the remaining outstanding shares. The only legal arrangement could have been to obtain the consent of the other subscribers, unless their subscriptions were void.

which clearly disclosed that the second plan was inconsistent with the first. He was not, however, informed of any facts indicating that the inconsistency had been resolved.† Indirectly, the Court was informed that it had not been resolved.††

The amount subscribed was between $375,000 and $400,000.00 without plaintiff's subscription, so that his subscription or the lack of it was immaterial to the right of the Insurance Commissioner to run defendant's business.* The judgment of termination was a judgment in rem as to the status of the defendant, and nothing more. It was not intended to and did not adjudicate the right of plaintiff to either accept or reject the Becker-Rummel plan, and obtain the return of his money. It is not res adjudicata as to the facts or as to the subsidiary questions of law.**

To adopt the defendant's construction of the Court's approval of the acts of the Insurance Commissioner and his deputy, is to convict him and his deputy—of participating in what would amount to a fraudulent and

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† The Court was informed (Exh. 65, p. 4) that under the December 10, 1956, resolution, the outstanding shares of stock should not be in excess of 40,000 shares with a par value of $200,000; and that 19,461 shares had been sold under that plan. It was also informed that under the Becker-Rummel proposal, the sale of the additional 38,377 shares was contemplated. The Court was not informed that plaintiff's consent had or had not been obtained.

†† Mr. Albertson specifically avoided telling the Court that the result of the refinancing would provide a policy holders surplus in excess of $400,000, which it should have done if the results of both refinancing plans had been considered. He qualified the statement by stating that "if the results of the refinancing were reflected back into December 31, 1956 financial statement," it would show that amount.

He also specifically avoided stating that the company had a paid in capital of $300,000. He said that if the Court approves the sale to the Becker-Rummel group, "all of the shares of stock will be in the hands of persons other than the Commissioner of Insurance, and the capitalization will again be reflected in the books at $300,000.

* Caminetti v. Imperial Mutual Life Insurance Co., supra.

** Freeman on Judgments, 1925 Edition, Sect. 689; Gratiot County State Bank v. Johnson, 249 U. S. 246, 39 S. C. 263, 63 L. Ed. 587; Manson v. Williams, 213 U. S. 453, 53 L. Ed. 869; Pickering Lumber Co. v. Whiteside, 128 Pac. (2) 899, 54 C. A. (2) 200; Woods v. Deck, 112 Fed. (2) 740 (C. C. A. 9); In re Courtney Bros., 100 Pac. (2) 471.

collusive* conspiracy to deliberately defeat plaintiff's known rights. The presumption of regularity of judicial proceedings forbids the adoption of this construction.**

The Court did not, of course, approve the illegal acceptance of the money into the Treasury in violation of the escrow agreement, because it was not informed of the facts showing that it had been violated. It could not create title, it could only confirm it. As to this money the Rehabilitator was a mere trespasser.***

If the construction adopted by the defendant were to be adopted, the judgment would be subject to collateral attack for several reasons. One is that it is a judgment obtained by extrinsic fraud and is subject to collateral attack.†

Another reason is that the Court had no jurisdiction over the subject matter,†† or over the person of the plaintiff. Plaintiff was not served with valid process, constructive service was not due process of law in this case, and in any event, the notice to plaintiff was insufficient for due process.††† The judgment is therefore void.****

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* With both the defendant and the Insurance Department being represented at the hearing by the same attorney, Mr. Philip Dolan—now President of the defendant—an inference of collusion would be virtually conclusive.

** Jones, Evidence, Sect. 47. Where a situation is explainable on the basis of legality, it will be assumed that such is the explanation. 17 C. J. S. 738.

*** Pickering Lumber Co. v. Whiteside, supra; Manson v. Williams, 213 U. S. 43, 53 L. Ed. 869, 29 S. C. 519; Porter v. Beha, supra; Clark, Receivers, Sect. 392, p. 654.

† Davi v. Belfior, 314 Pac. (2) 596, 153 C. A. (2) 325; Hazel Atlas Glass Co. v. Hartford Empire Co., 64 Sup. Ct. 997, 322 U. S. 238, 88 L. Ed. 1250; Griffith v. Bank of New York, 147 Fed. (2) 899; Freeman on Judgments, Sections 1234, 1237.

†† In Re International Milling Co., supra.

††† Pennoyer v. Neff, 95 U. S. 714, 24 L. Ed. 565; Coe v. Armour Fertilizer Works, 237 U. S. 413, 59 L. Ed. 1027.

**** Freeman on Judgments, 1925 Edition, Sect. 322; Hansberry v. Lee, 311 U. S. 32, 61 S. C. 115, 85 L. Ed. 22; Philadelphia Co. v. S. E. C., supra.

If the Idaho Statute is construed to permit the taking of plaintiff's property under the circumstances of this case, it would be unconstitutional on the ground that it would deprive plaintiff of his property without due process of law. The constitutional requirement that provision be made for non-assenting stockholders and creditors is not present in this case. It also, therefore, impairs the obligation of contracts.†

Plaintiff was not obliged to file a claim during the Rehabilitation proceedings. The Idaho statutes do not require the filing of a claim during Rehabilitation.††

Furthermore, the Idaho district court did not assume exclusive jurisdiction over actions against the defendant. The injunction did not cover actions against the defendant. The Court reserved the right to issue "further" injunctions, if necessary (Exh. 65),*** but did not do so.

IV.

Defendant argues that it cannot be returned to the status quo, because it claims it lost money on the Transatlantic Agency, and that plaintiff should be required to return the amount allegedly lost. This argument is frivolous.

The Agency agreement itself was not a part of the consideration flowing from the defendant to the plaintiff for the stock subscription. This consideration flowed from the defendant to the Transatlantic Corporation in exchange for services to be rendered the defendant by the

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† International Life Insurance Company v. Sherman, 262 U. S. 346; 67 L. Ed. 1018; Neblett v. Carpenter, 305 U. S. 297, 83 L. Ed. 182; Hessen Siak Shams v. State Bank of Bloomfield, 48 Fed. (2) 894.

†† In the matter of Bond & Mortgage Co., 271 N. Y. 545, 3 N. E. (2) 591; In the Matter of Lawyers Mortgage Co., 163 Misc. Rep. 680; Consolidated Laws of New York, Sects. 511, 512, 513, 514; Idaho Code, Sect. 41-3504, 3505, 3507, 3510.

*** Fletcher, Corporations, Sect. 7797, p. 372.

Transatlantic corporation. Even this consideration did not include a promise to guarantee the defendant against losses. The risk of underwriting loss was assumed entirely by the defendant.

The consideration which flowed from the defendant to the plaintiff was the **promise** to obtain Green Cards and excess limits, and facilities for France, Spain and Italy.* None of these things were obtained. Aside from the fraud, there was a total failure of consideration with respect to the collateral agreements, which were a part of the stock subscription agreement.

Plaintiff is not required to tender anything which was not a benefit under contract,** or undo acts of the other party.***

V.

Defendant's argument concerning its defenses of participation, ratification, and waiver is based upon the **evidentiary** facts that plaintiff was elected President of the company, that he signed the stock certificates, and other **evidentiary** facts which, standing alone may have a tendency to establish the **ultimate** facts necessary to establish these defenses. Defendant treats the evidentiary facts as if they were the ultimate facts although they are unrelated to each other, but are all related to undisputed, unexplained other facts, which conclusively remove them from the scope of the rule that the defendant is trying to invoke.

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* Williston, Contracts, Sect. 1325, 3 C. J. S. 204 (Implied obligation to cooperate by furnishing the Agent with the article that agent agreed to sell.)

** Duke v. Cregan, 91 Colo. 120, 12 Pac. (2) 354; 12A, Fletcher, Corporations 5604, p. 192.

*** Steele v. Scott, 221 Pac. 342, 192 Cal. 521; Russell v. Roscoe, 289 Pac. 185, 106 Cal. App. 293 (total failure of consideration); Simmons v. Calif. Inst. of Technology, 194 Pac. (2) 521.

Defendant is silent on the fact that the plaintiff's election was in the nature of a farce,* and that he was ousted without notice in order to violate his rights under the stock subscription agreement. It ignores the facts showing the repetition of the fraudulent misrepresentations,** and the concealment of the true financial condition of the defendant. It ignores the fact that negotiations between the parties were in progress during the entire relationship.*** It also ignores that plaintiff was at all times trying to mitigate a loss,**** and that the parties were in no event in para delicti.*****

Defendant doesn't deny or explain the existence of these facts. It treats them as if they are non-existent or as if they are wholly immaterial.

Defendant argues that plaintiff was obligated to prevent other money from coming in and to object to the termination of the Rehabilitation in order to preserve any of the rights which accrued to him as a result of the assistance he gave. At the time of plaintiff's subscription it was contemplated by both parties that someone other than plaintiff—because they wouldn't let plaintiff do it—was going to refinance the company and take control of the

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* McGrath v. Scherer & Co., 195 N. E. 919, Appellant's Brief, pp. 64, 65, 66, 67. The following cases are in point on this issue: Harper v. Tri State Motors, Inc., 90 Utah 212, 58 Pac. (2) 18; Viner v. Jones, 87 N. Y. S. 257; Peake v. Thomas, 308 S. W. 885; Samuels v. Smith, 196 N. W. 45 (Ia.); Nichols v. Yandre, 9 So. (2) 157 (Fla.); Horn v. Abbot, 168 N. W. 104, 110 Nebr. 403; Relle v. Mayfield, 69 S. W. (2) 167; McFarland Sanatorium, 137 Pac. 209, 68 Ore. 530; Arthur v. Griswold, 55 N. Y. 400.

** Commercial Bank of Minominee v. Widman, 301 Mich. 405, 3 N. W. (2) 323 (continuing tort); Fickensher v. Gamble, 85 Pac. (2) 885. See Ex. 52, Ex. 21, Ex. 59, Ex. 27, Ex. 43, Tr. 126, 127, 310, 117.

*** Reiniger v. Hassell, 216 Cal. 209, 13 Pac. (2) 737; Lobdell v. Miller, 250 Pac. (2) 357; White v. American National Life Insurance Co., 78 S. E. 582, 155 Va. 305; Meeks v. Commonwealth Bonding Co., 187 S. W. 681.

**** Trigg v. Jones, 48 N. W. 113, 46 Minn. 277; Bergstrom v. Pickett, 181 N. W. 343 (Minn.); Fosgate v. Nocatee Fruit Co., 299 Fed. 963; Grasgebauer v. Schneider, 31 Pac. (2) 93, 177 Wash. 43.

***** Karallas v. Shinns, 107 Pac. (2) 395, 41 Cal. App. 694; Hobart v. Hobart Estates Co., 159 Pac. (2) 958.

company, and that the rehabilitation order would then be removed.

Plaintiff agreed to this arrangement—somewhat reluctantly (Tr. pp. 55-201) because he was compelled to in order to mitigate the damage he had already suffered as a result of defendant's previous fraud and breach of contract* (Tr. p. 344). The removal of the Rehabilitation order was not part of the consideration for plaintiff's investment, but its removal was a very powerful inducing motive,** because he wanted to mitigate his damage. Defendant took full advantage of this to obtain, and later to retain plaintiff's subscription. The conditions attached to his agreement were part of the consideration. They were several and to be performed at different times.***

As to defendant's claim that plaintiff is trying to recover at the expense of innocent investors, who invested $750,000.00 in the defendant to rehabilitate it. None of these people intervened or even appeared at the trial of this case. The defendant is a going concern, so the fact that they do not elect to rescind is not a bar to plaintiff's action to rescind.****

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* Alder v. Crosier, supra, publication of a false financial statement, 50 Utah 437, 168 Pac. 83; Cromwell v. County of Sac, 94 U. S. 351, 24 L. Ed. 195; White v. Nashville & NW. Ry. Co., 54 Tenn. 518.

** Williston, Contracts, Sections 111, 130.

*** Williston, Contracts, Sects. 860, 1292.

**** Cattle Raisers Loan Co. v. Sutton, 271 S. W. 233.

No. 18,226.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT.

MORTON K. LANGE,
Appellant, Cross-Appellee,

vs.

LIBERTY NATIONAL INSURANCE COMPANY,
Appellee, Cross-Appellant.

Appeal from the United States District Court for the District of Idaho, Northern Division.

CROSS-APPELLEE'S BRIEF ON CROSS-APPEAL.

I.

Defendant's entire brief appears to be designed more to prejudice this Court against the plaintiff than it does to answer the arguments contained in plaintiff's brief. Instead of explaining why it failed to call material witnesses it has misrepresented the evidence in such a manner as to make it appear as if these witnesses had appeared and testified. Although the evidence at the trial was virtually undisputed, defendant raises fact issues in its brief, by mere assertions having no basis whatsoever in the evidence. It

also refers to facts contained only in hearsay documentary evidence, admitted by stipulation subject to a proper foundation, which were not referred to at the trial, as facts established by the evidence. Although defendant offered 49 exhibits, it identified only 10.* Some of these were self-serving declarations, and some purport to be admissions on the part of plaintiff, about which he was not cross-examined.** It does not appear that the trial court considered these exhibits, but that the defendant hopes that this court will. In particular, this refers to certain correspondence between the plaintiff and Mr. Becker, which although admitted by stipulation was not identified.

After reading this brief, we are more convinced than ever that the defendant prejudiced the trial Court against the plaintiff by means of a secret trial brief under Rule 9 j of the Idaho District Court. His oral remarks show that he was influenced by matters outside the record, the source of which could have only been the defendant.

This court cannot properly evaluate this case, unless it is made aware of the same brazen and calculated effort to prejudice it against the plaintiff. We have, therefore, corrected some of the most flagrant misstatements at the conclusion of this argument. We have included misstatements contained in defendant's brief on appeal as well as on the cross-appeal, because they are pertinent to the overall effort to prejudice this Court, and in particular in connection with the cross-appeal. Defendant is obviously well aware that its only hope of upsetting the findings of the Trial Court on the cross-appeal is to prejudice this Court by misstating the evidence, and confusing the issues.

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* Our original brief incorrectly shows that all of the Exhibits offered were plaintiffs exhibits. Exhibits 1 through 49 were plaintiffs. Exhibits 50 through 89 were defendants (P. T. O., p. 30).

** Esnault-Pelterie v. Chance Vought Corp., 56 Fed. (2) 393 (D. C. N. Y., 1938).

The defendant has especially flagrantly gone outside the record to prejudice the Court against the plaintiff in connection with this argument. Its statement, without any page reference to the record, that plaintiff took advantage of his control over the corporation to accumulate $50,000.00 or more in premiums to provide himself with a personal offset against the company; its statement that plaintiff was responsible for the corporation failing and refusing to make an accounting for the premiums collected until the pretrial order was entered, and its statement that plaintiff misappropriated the funds of the defendant* are statements which not only have no basis whatsoever in the record, but which are utterly and completely false. The undisputed evidence shows that the defendant violated its duty to Transatlantic in many respects and that there are many matters of legitimate dispute between them. There is nothing whatsoever in the record to show that Transatlantic, or plaintiff, at any time failed to account for any premium, any cancellation, or any payment collected or made upon behalf of the defendant. Had the defendant had such evidence, it certainly could have, and undoubtedly would have, produced it. Or it would have at least cross-examined plaintiff on the issue, in which event it would have been clear in this Court.

We do not expect this court to become involved in trying to decide fact issues in matters outside the record. We can only answer these charges by showing that they are outside the record, and by demonstrating that the dispute between the Transatlantic and the defendant involves the amount **due** under the contract, if anything, and not the amounts **collected** or **disbursed**. As to the latter the parties are in agreement.

The Agency Contract (Ex. 1) provides for a commission of 35%, except for Class 4 and 5 personnel (25%). It

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* In this connection see Chicago Fire and Marine Ins. Co. v. Fidelity and Deposit Company, 18 Pac. (2) 260, 41 Ariz. 358.

also provides for an adjustment at the end of each calendar year based upon paid losses, and a final adjustment upon termination of the Agency, "when all losses shall have been fully adjusted and paid." The stipulated conditional account-stated (P. T. O. p. 24) is based upon a commission schedule of 27½% for the first six months of 1957 and 30% prior thereto and thereafter. It does not purport to be, and expressly avoids being, a stipulation that the amount set forth therein is due and owing from the Transatlantic to the defendant, or that this is the applicable commission schedule. The amendment for the year 1957 specifically provided that it applied to that year only, and even that amendment was agreed upon, subject to conditions which were not fulfilled. Transatlantic, therefore, has a right to invoke the schedule provided for in the original contract, which in no event, would be less than the 30% for the entire year 1957. This is true, even though it may have withheld only 30% part of that time instead of the 35% it was entitled to withhold.*

The burden of proof was on the defendant to prove the terms of the agreement upon which the account was founded, and that it had fully performed the conditions of said agreement, and the amount due.** Also to establish that the contact was modified, if it was modified.*** The defendant failed to meet this burden of proof.

The defendant failed to show an up-to-date loss ratio based upon paid losses, or any loss ratio whatsoever. It tried to establish that the commission schedule set forth in the contract had been superceded by the schedule based on the loss ratio, by means of an "estimate" of company losses, which was pure opinion evidence with no evidentiary value, whatsoever. Transatlantic is entitled to a

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* Hulen v. Stuart, supra; Wann v. Diablo Finance Corp., supra, O'Shea v. Vaughn, supra; Williston, Contracts, Sects. 689, 690.

** Urdangen v. Edwards, 174 N. W. 769, 187 Ia. 1005, 1 C. J. S. 604.

*** The Jobs Haven, 270 Fed. 60.

full accounting based upon paid losses, and a final figure as to the actual loss ratio, before the amount due can be determined. Since the termination of the Agency contract, this information is solely within the knowledge of the defendant. Transatlantic is certainly not required to accept an "estimate" and especially not, in view of the past reserve juggling history of this company.

These losses were not material to the issue of the right of the plaintiff to recover his stock subscription. Under the evidence in this case plaintiff was not required to contest this issue, and did not. Transatlantic, however, has a right to dispute these alleged losses, and to show that they were attributable to excessive Home office expenses, excessive reinsurance rate, excessive brokerage fees for obtaining the business in the first place, or all of these, rather than from excessive losses due to claims.

In this case plaintiff is entitled to the benefit of an unfavorable inference against the defendant for producing "inferior" evidence when "superior" evidence, i. e., the actual loss figures, were available. It can be inferred that the superior evidence, if produced, would have been unfavorable and would have established that the Transatlantic was not indebted to the defendant in any amount whatsoever, based upon claims actually paid. This inference is strengthened somewhat by the intimation in the evidence that after the termination of the agency contract the defendant would not and did not properly pay its claims (Tr. pp. 255, 256, 359), and that they were still not all paid. Certainly, if the defendant was serious about this counterclaim it would have produced the strongest evidence available.* Of course, if it can prejudice this court by leading it to believe that plaintiff led this company into a disaster operation, it will have accomplished its purpose.

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* Wigmore, Evidence, Sect. 285.

The defendant had a legal right to terminate the Agency at any time after December 31, 1957. The uncontradicted evidence shows that it needed, depended upon and received the benefits of the Agency contract (Tr. pp. 182, 183) and that it not only continued it after December, 1957, but also that it induced the Transatlantic to continue for almost a year after the first termination notice, by making promises it did not keep (Tr. pp. 137, 138, 139, 140).

Defendant, however, recognizes Transatlantic's claim in the above respect, as well as its claims for fraud,** breach of contract, claims for services rendered, extra expenses and other claims mentioned in the evidence by suggesting (p. 35 of its brief) that they be made the subject of a suit between the Transatlantic and the defendant. It could have, but didn't, make Transatlantic a third-party defendant in Missouri had it been willing to risk being subjected to trial on these claims which belong to Transatlantic, but not to plaintiff in this case. Obviously, if it can divert the court's attention from plaintiff's very legitimate claim against it, and defeat this claim simply by talking about its counterclaim, rather than proving it, it will have accomplished a very satisfactory result.

In any event, the Transatlantic is entitled to retain the possession of the money claimed by the defendant under the express terms of the contract, and, as well, because it has the right of set-off and counterclaim against them for claims arising out of the same transaction.*** These issues could have been tried in the garnishment proceeding had the defendant not entered its appearance (P. T. O. p. 12) and dissolved the attachment, or if the defendant had made

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** Alder v. Crosier, supra (damages from a false financial statement).

*** Massachusetts Bonding and Ins. Co. v. Johnson & Harder, Inc., 199 At. 216, 330 Pa. 336; Spears v. Netherland Ins. Co., 31 Tex. C. A. 567, 72 S. W. 1018, 2 A. L. R. 133; Restatement of the Law of Agency, Sect. 464 (2nd Series); Downey v. Humphries, 227 Pac. (2) 484.

the Transatlantic a third-party defendant. They are, in any event, matters between the Transatlantic and the defendant, and not matters between the plaintiff and the defendant, and certainly not in this case,**** because the demands are not "mutual."

Before the obligations of a corporation will be recognized as the obligations of a particular individual, it must be shown that an adherence to the fiction of the separate existence would, under the particular circumstances sanction a fraud or promote an injustice.* The fact alone that an individual owns and controls the corporation is not sufficient. And the person making the claim must be able to sustain a claim against the corporation.** To set aside the corporate entity in this case, would sanction a fraud and promote an injustice on the part of the defendant rather than on the part of Transatlantic or the plaintiff. It would deprive both of a right to be heard on the legitimate issues between them and the defendant.

The court correctly ruled that the Transatlantic was an indispensable party to this action,*** not only on a technical legal ground, but on a basis of justice and equity. There is no evidence in this case that plaintiff has drained the corporate assets to defeat defendant's claim. The converse is true. The corporation, and the defendant had drained plaintiff of his. There is no evidence that Transatlantic cannot, or will not pay defendant's claim

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**** Looney v. Thorpe Bros., 277 Fed. 367; Schomberg v. Platt, 36 Oh. App. 118, 172 N. E. 685; Alden v. Central Power Corp., 137 Fed. Supp. 924.

* Homebuilders and Suppliers v. Timberman, 75 Ariz. 357, 256 Pac. (2) 716.

** Southeast Securities Co. v. Christenson, 66 Ida. 233, 158 Pac. (2) 315; Miller Lumber Corp. v. Miller, 357 Pac. (2) 503, ... Ore. ...; Wheeler v. Smith, 30 Fed. (2) 59 (C. C. A. 9, 1929); In re John Koke, 38 Fed. (2) 232, 363 Pac. (2) 1075; Oregon State Highway Commission v. Brassfield, 363 Pac. (2) 1075.

*** Chidester v. City of Newark, 162 Fed. (2) 598; Alden v. Central Power Corp., 137 Fed. Supp. 924; State of Washington v. United States, 87 Fed. 421; Metropolis v. Barkhausen, 170 Fed. (2) 481; Truman Homes Corp. v. Loan Holding Co., 88 N. Y. S. (2) 403.

in the unlikely event any amount is ever found due. The only ground that defendant established for setting aside the corporate entity in this case is that it doesn't dare to bring a suit to enforce the claim it alleges it has, but did not prove.

In view of the above, defendant's insinuations that plaintiff used his election as President to avoid having the bond renewed and to obtain concessions for the Transatlantic, are wholly immaterial. They are of course frivolous, as well. Mr. Albertson was in full control during the entire time plaintiff was supposedly acting as President, and plaintiff had no authority whatsoever.

The Trial Court correctly ruled that defendant's claim, if any was against the Transatlantic, not against the plaintiff, and its judgment should be affirmed.

Corrections of the Misrepresentations and Distortions of, and the Omissions From the Evidence Contained in Defendant's Brief.

Defendant's Brief, p. 3: "which order (of Rehabilitation) enjoined the officers and directors from taking any action with respect to the affiairs of the defendant, except with the written permission of the Rehabilitator." P. T. O. p. 14, Ex. 14.

The evidence: The injunction (Ex. 65) enjoined the officers and directors from transacting any business of the defendant, from wasting, handling or disposing of any of the property of the defendant, or from interfering in any manner whatsoever with the Rehabilitation. It did not enjoin the stockholders from selling their stock or from holding elections, and electing officers and directors.

Defendant's Brief, pp. 6 and 10: The source of the money upon which said check was drawn was the Transatlantic Casualty Underwriters, Inc., which company was then in-

debted to the defendant for premium moneys collected but not remitted in the amount of approximately $75,000.00 that represented most of its cash on hand at that time".

The evidence: (Tr. p. 168) Plaintiff testified that as of the 15th of December, 1956, when he came to Coeur D'Alene, the Transatlantic would have owed the company for the October statement, amounting to $29,000.00 or $30,000.00; that it had probably collected $75,000.00 at that time, but it was not due. That at that time the Transatlantic had in cash $87,340.00, accounts receivable of $40,000.63, and that plaintiff had personal assets of a little bit more than $30,000.00; that the defendant owed the Transatlantic at that time, approximately $15,000.00 for money advanced to pay claims (Tr. p. 262); that plaintiff advanced money to the corporation before the Rehabilitation (Tr. p. 148) and repaid all, almost all of his personal assets back into the Corporation (Tr. pp. 262, 263) and that the corporation is indebted to him (Tr. p. 257). Although the plaintiff produced all of the Transatlantic records for examination by the defendant (Tr. p. 262) defendant offered no evidence whatsoever to contradict plaintiff's evidence on this point.

Defendant's Brief, pp. 14, 22, 23, 31: "That plaintiff communicated with Mr. Becker relative to such purchase and wired him that **he wouldn't oppose** such sale if the other stockholders favored it." p. 14; "that the plaintiff had been soliciting and encouraging the Becker group for weeks", p. 22; "that plaintiff was relying upon such refinancing" (by the Becker-Rummel group), p. 22; "plaintiff even sent a telegram to Mr. Becker on April 7, stating **he had** no objections to his group **buying the remaining 38,000 shares**", p. 22; "pursuant to such indicated approval an option was taken on all of said stock by the Becker-Rummel group on March 25, 1957 under which the purchase was conditioned on sufficient approval

by the defendant stockholders", p. 22; "Plaintiff testified that he was willing to retain his stock in the defendant, and go along with the Becker management, and later wanted Mr. Becker to buy him out". p. 24; "Plaintiff thereafter issued the stock certificates to himself and others * * * and **solicited** large funds from the Becker-Rummel group, p. 31 (Allegedly after he learned that the money had been turned over to the defendant)."

The evidence:

(The clarification of the half-truths contained in defendant's brief, in connection with the sale of the stock to the Becker-Rummel group requires an analysis of evidence and events which, when omitted, create an impression not in accord with the facts. The time of the occurrence of these events is also material. We are therefore listing them in the order of their occurrence.)

Jan. 6, 1957: Plaintiff was informed by Mr. Albertson that a financing proposal under which plaintiff would have control of the company for a period of three years was not acceptable to the Insurance Department, because it did not want an agency to control the company. On the same day the Becker-Rummel group commenced negotiations to purchase a controlling interest in the defendant (Deft's brief, pp. 4 and 7, P. T. O. p. 17, Tr. p. 53).

Jan. 25, 1957: Mr. Becker wrote plaintiff confirming a previous conversation, and asking plaintiff whether he was willing to sell enough of his shares to insure control of the company. Plaintiff did not want to sell to the Becker group because they were investment people, and because he thought control should remain in Idaho, so he advised Mr. Becker that he did not want to sell until he knew more about his group and their plans for the company. Tr. p. 86.

March 1, 1957: Mr. Albertson advised plaintiff (Ex. 57) that the Wester offer had been withdrawn, and that he again recommended that plaintiff consider his own ability to refinance the company.

March 10, 1957: Mr. Albertson advised plaintiff (Ex. 59) that the possibilities of refinancing rested upon the Becker group, and upon plaintiff.

March 18, 1957: Plaintiff telephoned Mr. Becker and asked him **what his intentions were**, with respect to the refinancing, and he advised plaintiff that he didn't know, that he didn't have anything definite, and that investigation was still underway. On March 22, Mr. Becker advised plaintiff by wire that his group had taken an option on a controlling interest (Tr. pp. 86, 87). Plaintiff did not testify that he solicited the Becker-Rummel group. There was no testimony to that effect. Mr. Becker did not testify. Exhibit 78 is a self serving document, about which plaintiff was not even cross-examined.

March 18, 1957: Mr. Albertson wrote plaintiff (Ex. 22) that the "people with whom he had been consulting" had advised the sale of the 38,377 shares of stock; that the Becker-Rummel group had made a proposal to buy these shares, but not to buy the shares of the old stockholders; and that the Stuyvesant Insurance Company was willing to buy the 38,377 shares of stock and also to buy all of the shares of the subscribers under the minimum financing proposal. He also advised plaintiff that either one of these deals would "certainly take the pressure off the company's operations in Germany, and requested plaintiff's reaction by return cable. Plaintiff did not answer this letter, because he did not understand the situation there, and for the same reason he had not signed and returned the stock Mr. Albertson had sent him on Feb. 25 (Tr. p. 82).

March 25, 1957: A stockholders' meeting was held by the defendant to authorize the sale of the 38,377 shares of stock. The meeting was held without notice to plaintiff, was attended by the old stockholders only and was presided over by R. S. Nelson as President of the Company and Chairman of the Board. Two days later, the sales contract was signed (Exs. 24, 26) with the Becker-Rummel group.

March 29, 1957: Plaintiff received a telephone call from Mr. Albertson asking him to support the Stuyvesant proposal, which plaintiff agreed to do. Plaintiff testified that he did not favor the Becker-Rummel group because they were investment people, not insurance people (Tr. pp. 85, 86).

March 29, 1957: Plaintiff cabled the Stuyvesant Insurance company that he would cooperate with them in their efforts to purchase the defendant. On the same day he wrote Mr. Albertson that he did not feel that he had been well enough informed to express an opinion about either one of the two proposals.

March 30, 1957: Plaintiff signed and returned the stock certificates to the secretary of the Company with a letter (Ex. 23, Tr. pp. 81, 82, 83) of the same date cautioning him against issuing the stock until the "rights of the new stockholders had been clarified." The defendant, nevertheless, issued the stock, although the March 31st financial statement showed a decrease in surplus of over $100,000.00 (Ex. 38). Plaintiff was not advised of this statement until April, 1960.

April 2, 1957: Plaintiff received Exhibit 25 urging his support of the Becker-Rummel proposal, in which Mr. Becker advised plaintiff that unless he did his clients might withdraw (Tr. p. 85). Plaintiff proceeded to London to meet the Stuyvesant people, and telegraphed his address in London to Mr. Becker (Tr. p. 88).

April 3, 1957: A meeting of the Board of Directors of the defendant was held and the contract of sale entered into between the old stockholders and the Becker-Rummel group was approved subject to the amendment that approval be obtained from only 70% of the owners of the 21,623 shares "now sold or allocated". Plaintiff received notice of the meeting on April 4 (Tr. p. 89). The meeting was presided over by Mr. Philip E. Dolan in the absence of the President, Mr. Morton K. Lange.

April 3, 4, 1957: Plaintiff was negotiating with the Stuyvesant Insurance Company, when he was notified that the stock had been sold to the Becker-Rummel group without his consent, and that there was apparently nothing he could do about it (Tr. p. 89).

April 4, 1957: Mr. Dolan wrote to plaintiff that several proposals for refinancing were being **considered,** and that something should be known soon. Also that additional savings of about $50,000.00 on claims reserves could be expected, in his opinion.

April 5, 1957: A waiver and consent was sent to plaintiff with a request that plaintiff sign and return it to signify his approval of the sale to the Becker-Rummel group. Plaintiff did not return this consent and waiver and has never done so (P. T. O. p. 23). The stock was sold to the Becker-Rummel group on March 27, and the amendment approved on April 4, before plaintiff's approval had been asked for, or indicated.

April 7, 1957: Plaintiff returned to Munich, tried to call Mr. Becker, and finally cabled Mr. Becker that **he knew of** no objections to his clients proposals, and that **they could expect no trouble from plaintiff** if the other stockholders were in favor thereof (Ex. 25, Tr. p. 93).

April 11, 1957: Plaintiff telephoned Mr. Becker about the sale of the stock. Mr. Becker advised plaintiff that

his clients would buy all or any part of plaintiff's stock. Also that his group did not contemplate the termination of the German business. In reliance upon these statements plaintiff decided not to attend the stockholders meeting of April 15, 1957, and made arrangements with his associate, Mr. Smith, to meet with Mr. Becker to arrange to have him buy the stock. Mr. Smith contacted Mr. Becker in New York, but Mr. Becker avoided seeing him (Tr. pp. 95, 96). Plaintiff testified (Tr. p. 96) that he would not have objected to the sale to the Becker-Rummel group **if they would buy his stock.** Plaintiff did not attend the stockholders meeting, because he thought Mr. Becker would buy the stock (Tr. p. 95). Mr. Becker confirmed that plaintiff offered to sell the stock by letter dated April 26 (Ex. 33). At the meeting of April 15, the stockholders present approved the sale to the Becker-Rummel group.

April 20, 1957: Plaintiff received a telegram from Mr. Albertson (Ex. 31) threatening him with a breach of the terms of the Agency contract, which had been agreed upon at the time of the stock subscription (Ex. 31).

April 21, 1957: Plaintiff employed an attorney to protect his interests which attorney wrote the defendant and notified it that plaintiff questioned the legality of the stock sale (Ex. 32).

April 26, 1957: Mr. Becker advised plaintiff that he, and his clients had purchased a controlling interest in the defendant, confirmed that Mr. Smith had advised him that plaintiff would not attend the stockholders meeting, and would like to sell his stock to his clients. With this letter, negotiations commenced with the Becker-Rummel group which continued until the end of the relationship (Tr. pp. 102 through 120, 137 through 142).

Defendant's Brief, p. 25: "Plaintiff voted his stock at a special stockholders' meeting of defendant in November, 1957."

The evidence: Plaintiff voted his stock at a special stockholders meeting of defendants in November, 1957, by proxy at Mr. Becker's specific request, "because Mr. Chapman had been fired and was expected to make trouble".

Defendant's Brief, p. 25: "Even after he had made **"some claims"** of being defrauded, plaintiff signed his own stock certificate, and those of the other members of his "group", which other members invested about $100,000.00" * * * some of whom relied upon him (plaintiff) in making their investment.

The evidence: Nobody testified and there was no evidence that plaintiff was a member of any group. There is not a word of any testimony from any witness, or any evidence in any document that any investor relied upon plaintiff in making his investment. Defendant makes no page reference to the record to support this statement. The only claim of fraud plaintiff had made previously specifically referred to Mr. Albertson's agreement to permit joint control made with the intention of not carrying it out (See Ex. 27).

Defendant's Brief, p. 20: "Plaintiff should have known about the accuracy of some important items in the financial report, "for it later developed that it was his own German business that caused substantial losses for the defendant in 1956."

The evidence (Tr. pp. 225-226): Plaintiff testified that the Agency was writing a considerable amount of insurance for the Liberty National at the end of 1956; that the company had to take his word for the amount of claims reserve to set up on these writings; and that he had no recollection of having sent in quite a large bunch of new claims after he returned to Germany. Nobody testified that plaintiff did send in a bunch of new claims, nobody

testified or contended that the reserves for the German business were not accurate.

The defendant's conclusion in this respect has no basis in the evidence whatsoever.

Defendant's brief, page 17: "While plaintiff incredibly denies that he had knowledge that such was going to happen" (The acceptance of the money before March 15).

The evidence: Plaintiff did not deny that he knew the money was going to be accepted before March 15. He claims that he did not know the money would be accepted before the joint control order went into effect, and unless and until sufficient funds had been subscribed in accordance with the terms of the subscription.

Defendant's brief, page 18: "By the end of March, 1957, however, the defendant's capital was again impaired 'due to further losses' ".

The evidence: The Defendant made no explanation of the decrease in surplus between January 11 and March 31, 1957, and there was no evidence to establish the further losses, or what they were.

Defendant's brief, page 21: "Plaintiff's Agency was never profitable for defendant, and from January, 1957 it caused losses to the defendant of more than $100,000.00."

The evidence (Tr. p. 359): Mr. Dolan testified: "It never did run off profitably, so **'obviously'** there were losses. **I can not give you an exact figure,** but I would approximate it at $100,000.00, because our losses are still continuing." Defendant's **"estimate** of $100,000.00 **or more"** in the evidence becomes an established figure of **"more than"** in its brief (Emphasis ours).

Defendant's brief, page 21: "The defendant's management made diligent efforts to obtain Green Cards to **'please'** plaintiff."

The evidence (Tr. p. 373): Mr. Dolan testified: "There was an effort to be made to get Green Cards, and that was one of his conditions when he was out there in December and January, that the question was when they could get the Green Cards, and 'you bet' the company was to attempt to get them for him." Nobody **testified** that the repeated promises and efforts to obtain Green Cards were to please plaintiff.

Defendant's brief, page 24: "The Rehabilitator would not have recommended that defendant be discharged **without** the investment of plaintiff, the Becker-Rummel group, and the other subscribers."

The evidence (Tr. p. 350): Mr. Albertson testified that if the money of plaintiff **and** of the other stockholders had not been in the treasury, he would not have recommended the company for discharge. In answer to the direct question from the Court as to whether he would have discharged, if plaintiff's money was not there, he testified only that if plaintiff's money had not been in the treasury in January, the company would have been liquidated.

Defendant's Brief, page 10: "The evidence shows that plaintiff attempted to largely condition his investment on benefits that would accrue to his Transatlantic Company at better commission rates."

The Evidence: Both plaintiff (Tr. pp. 76, 77) and Mr. Smith (Tr. p. 297) testified that the commissions were reduced not increased. This was corroborated by all of the correspondence, Exhs. 8, 9, 57, 58, 33, and defendant's own statement on page 16 of his brief that the commissions were higher than the defendant felt obliged to reduce them in October, 1956. The tentative change was made in October while the Rehabilitation was still being concealed from plaintiff as was the 5% override being charged by the Reinsurance agency. The amendment to the agency

contract, plus the elimination of the 5% override, plus the 20% increase in rates (see Ex. 52) meant an overall advantage to the defendant of from 27½% to 30% over the previous year.

Defendant's Brief, pages 9 and 33: "It is admitted that the Transatlantic Casualty Underwriters, Inc., has collected insurance premiums on behalf of the defendant in Germany which it has refused and still refuses to pay over to the defendant in the amount of $49,297.58.

"He took advantage of his control over the corporation to accumulate $50,000.00 or more in premiums due to provide himself with an offset on his personal claims against the company.

"He went through the formality of attaching these funds, but never carried through to the point of answering the writ of attachment although it was long past due."

The Evidence, P. T. O. page 24: "In connection with plaintiff's cross-claim it is admitted that the amount of premiums collected by the Transatlantic Casualty Underwriters, Inc., **based on a commission rate of 27½% for the first six months of 1957 and 30% prior thereto and thereafter is $49,297.58.**"

The Evidence continued, P. T. O. page 12: "Defendant appeared (in the attachment proceeding) and removed the case to the United States District Court, on the ground of diversity of citizenship, and at the same time filed its answer and counterclaim and cross-complaint. * * * Plaintiff not having filed a bond, **after** defendant's appearance and answer, the attachment was automatically terminated ten days subsequent to the filing of defendant's answer.

Exhibit No. 1: The rate of commission mutually agreed upon for this class of business shall be:

(a) Private passenger vehicles

Policies covering on classes 4 and 5.... 25%

All others 35%

(Note: The contract also called for a provisional commission based upon the loss ratio, concerning which there was no evidence.)

Tr. p. 360 (Testimony of Mr. Dolan): I talked to plaintiff on the telephone on several occasions. He did say that he was going to accumulate premiums. Frankly I would have stopped writing for him, but Mr. Becker didn't. (Note that Mr. Dolan did not negative Transatlantic's claim to possession of the money claimed under the express terms of the contract, which Mr. Becker very obviously recognized by not stopping writing.) Mr. Becker, with whom plaintiff dealt, did not testify.

CONCLUSION.

We submit that the evidence in this case is so clearly and overwhelmingly in favor of plaintiff's recovery that this Court is more than justified in reversing the judgment of the trial Court and granting rescission.

There is much more, however, involved in this case than plaintiff's $50,000.

It was not intended, we submit, that the Rehabilitation Statutes were to be used to extract money from innocent investors for the purpose of paying the debts of a company, and to rehabilitate it at their expense. According to defendant's own statement, that is precisely what occurred in this case.

By putting the stamp of approval on the company's action in this case, the Court will not only approve an injustice to plaintiff, it will give this company with same officers as before—only more experienced in the art—and

other companies similarly inclined, the go signal to repeat again and again what they have accomplished in this case.

Respectfully submitted,

THOMAS A. MITCHELL,
Attorney for Appellant.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

.....
Attorney for Appellant and Cross-Appellee.

Service of the above and foregoing Brief of Appellant is hereby admitted and three copies have been received by me this .... day of May, 1963.

.....
Attorney for Appellee and Cross-Appellant.

APPENDIX A.

Feisthamel v. Campbell, 55 Cal. App. 774, 205 Pac. 25 (1921).

"It is uniformly held to be the law that the wrongful delivery by an escrow holder, contrary to instructions under which he holds the property, will confer no title, particularly as against those who take with notice. We have already suggested that upon performance of the condition required of the vendee, the escrow holder or trustee no longer holds the property as the property of the vendor, but for the vendee; and that the remedy of the vendee in such a case is against the trustee or escrow holder to compel delivery of the subject of the deposit. There was in this case a wrongful delivery of the certificate of stock to Dent * * *. The vendees having available to them the remedy to compel the depository to turn over the stock, we think that the remedy followed the stock into the hands of the person who wrongfully became possessed of it."

People ex rel. Conway v. Metropolis Fire Ins. Co., 239 N. Y. S. 55, 136 Misc. 133.

"It will be observed that the insurance company under its agreement could become entitled to moneys held by the bank only upon fulfillment of the conditions set forth in paragraph 4 of the agreement. Without its fulfillment of these conditions, the insurance company could claim no right of property therein. These conditions were not complied with, and cannot be complied with because the insurance company has dissolved. The insurance company at the time of the dissolution had no title to these moneys, and hence none can pass to the Superintendent of Insurance in the liquidation proceedings. The bank holds them under a valid trust agreement and it is bound to discharge its obligations thereunder."

Note: In this case money was paid in trust to the bank under a stock subscription agreement which was conditioned upon the reorganization of the insurance company.

McDonald v. DeFremery et al., 168 Cal. 199, 142 Pac. 77.

"It is to be noticed that the Court utterly fails to find whether or not the report was or was not false in any essential particular, precisely as it fails to find upon the good faith of the defendants, which they pleaded to the effect that whether correct or incorrect, the report was but an expression of opinion upon questions of value. * * * an expression of opinion, to avoid an action for deceit, must be the expression of an opinion honestly entertained by the person making it. * * *

"It is sufficient, in order to maintain an action for deceit that the false statement was one, although it may not have been the sole inducement for the purchase."

Farmlands Development Co. v. Taft, 186 N. W. 431 (Iowa, 1922).

"Subscriptions to stock may be made upon a condition precedent, and when made constitute a contract between the several subscribers, which cannot be withdrawn or revoked by anyone without the acquiescence of all. It is a continuing offer—a conditional subscription. Such subscription, when the conditions are complied with, are binding upon the parties to the same extent as if the contract had been absolute and unconditional. Cravens v. Eagle Cotton Mills Co., 120 Ind. 6, 21 N. E. 981; Armstrong v. Kausner, 47 Ohio St. 276, 24 N. E. 897; Richelner Hotel Co. v. Circumpmit Co., 140 Ill. 248, 29 N. E. 1044; Minneapolis Threshing Machine Co. v. Dover, 40 Minn. 110, 41 N. W. 1026; Lake Ontario v. Mason, 16 N. Y. 451, 14 C. J. S. 535."

Campbell v. Coin Machine Mfg. Co., 188 Pac. 197, 96 Oreg. 119.

"Shares of stock are defined as: The right to participate in a certain proportion in the immunities and benefits of the corporation, to vote in the choice of their officers, and the management of their concerns, and to share in the dividends and profits, and to receive an adequate part of the proceeds of the capital on winding up and terminating the active existence and operation of the corporation.

"The five shares of capital stock of the par value of $10.00 proposed to be delivered to plaintiff by defendant would not comply with defendant's contract to deliver to plaintiff five shares of capital stock of the par value of $100.00 each in a corporation with a capital stock of $4,000,000. The plaintiff might desire to pledge his shares as security for a loan, or he might desire to sell the same, and to tersely express it, it would be entirely different stock."

McClunn v. Central Trust Co., 165 N. Y. 108, 58 N. E. 777.

"When dealing with sales of securities there are implied representations which flow from the fact of sale * * * The sale itself may give rise to implied representations just as effective as if the seller had made express statements to same effect.

Harper v. Tri-State Motors, Inc., 90 Utah 212, 58 Pac. (2) 18, the Court said:

> These facts, if not explained, or if their effect be not explained by other evidence, might well be regarded by the trier of facts as evidence that he did participate in the transaction. The fact that he signed the stock certificates is alone strong evidence of that

fact, and in the absence of other evidence might be sufficient to support a finding against him. But there is other evidence, if believed by the trial court, * * * which shows beyond peradventure that Holbrook took no part in the transaction whatsoever.

In Peake v. Thomas, 308 S. W. 885, it was held that a director of a bank could not be held liable for information the cashier of the bank concealed from everyone. The Court said:

"A director of a corporation will be charged with a knowledge of the facts concerning the company condition, which is presumably within his knowledge, yet such rule can only mean such facts as he knows, or by the exercise of ordinary care could have known, the appellee cannot be held accountable for failing to disclose this shortage.

"The evidence shows that the cashier had so skillfully concealed his speculations that repeated examinations by the State Banking Authorities had failed to discover them. Appellee did not actually know of this shortage. There were no circumstances present to excite his suspicions. It is not shown that they could have discovered what the State Banking Examiner had failed to find. Appellants own son who succeeded appellant on the Board of Directors failed for almost two years to find out not only about this shortage, but about others which were added to it during those years. It cannot be said that the Appellee, in the exercise of ordinary care could have discovered the fact of this shortage, and hence he cannot be charged with constructive notice of it."

Samuels v. Smith, 196 N. W. 45.

The Court said: "The crucial question is whether there was any bad faith on Smith's part in such profession o

confidence. A careful reading of the record satisfied us that Smith had implicit confidence in the desirability of the investment; that he never assumed any relation of agency to the corporation; that he never received any compensation of any character; that he never profited directly or indirectly by any sale of stock made; that on the contrary, he was a heavy loser personally, as stockholder having acquired altogether more than $7,000 worth of stock. The trial Court properly ruled that he was guilty of no bad faith or wrongful conduct of any kind in relation to the defendants."

Trigg v. Jones, 46 Minn. 277, 48 N. W. 1113.

"a careful persual of the evidence satisfies us that while plaintiff was informed by letter as early as August, 1887, that the deed had been delivered, yet the information was accompanied by statements that and assurances by Jones that the original arrangement would be carried out or was being carried out, so that he would get his stock as agreed, and that Cook would return the deed, or reconvey the property, which were calculated to keep plaintiff quiet, and allay any possible fears on his part; and that influenced by these considerations, he made no express repudiation of Jones' act, but let matters rest, hoping that the deal would be consummated according to agreement, and he get the stock to which he would be entitled. At the insistence of Jones he sent a proxy to one Mohle authorizing him to subscribe to stock; but that finally having discovered that the whole deal had fallen through, and would never be consummated, he brought this action to recover either the land or the damages. * * * This amounted to nothing more than an effort on plaintiff's part to avoid loss, which is not such a ratification as will relieve the agent."

Grasgebauer v. Schneider, 31 Pac. (2) 93, 177 Wash. 43.

"The rule permitting performance of acts in affirmance of an executed contract after discovery of fraud, without waiving an action for deceit, also applies to contracts which have been only partly performed at the time of the discovery of the fraud. Bean v. Bickley, 187 Ia. 174 N. W. 675. Among illustrations of the rule are two which apply here. One is where the party defrauded will lose a profit, which he would have enjoyed had he been fairly dealt with. Another is where the rescinding party cannot be restored to his original position. In this case the respondents' efforts be accepted as true, the respondents have lost the benefit of their bargain as it was represented to them, and also the benefits of the efforts they have expended on the property."

The case of Cromwell v. County of Sac, 94 U. S. 351 24 L. Ed. 195 is in point. There the Court said:

> "Various considerations other than the actual merits may govern a party in bringing forward grounds of recovery or defense in an action, which may not exist in another action upon different demand, such as the smallness of the amount, or value of the property in controversy, the difficulty in obtaining the necessary evidence, the expense of the litigation, and his own situation at the time. A party acting upon considerations like these ought not be precluded from contesting in a subsequent action other demands arising out of the same transaction."

In White v. Nashville & N. W. Ry. Co., 54 Tenn. 518 the rule is stated as follows:

> "Waiver is a relinquishment of, or a refusal to accept a right. The waiver of one of several rem

edies, or the waiver of a remedy as against one of several parties, does not extinguish the right. Thus it is said that a party may waive a part of his right and sue for the other part."

Reiniger v. Hassell, 216 Cal. 209, 13 Pac. (2) 737.

"Where a person protests promptly on discovering that he has been defrauded in making a contract, and enters into negotiations for a peaceful settlement which fail, a complaint filed within a reasonable time after such failure is not barred by laches."

Fickensher v. Gamble, 85 Pac. (2) 885.

"It should also be borne in mind that the deal was made up of a series of contracts, consisting of three exchange agreements and numerous escrow instructions. Plaintiff did not waive the fraud of the original representations by entering into the later contracts by reason of the fact that during the entire course of the transaction she remained unaware of the fraud which was being perpetrated upon her."

Wann v. Mount Diablo Finance Corporation, 23 Pac. (2) 303, 132 C. A. 621.

The fact that the fund of $25,000.00 was not built up (as represented at the time of the subscription) does not of itself give plaintiff cause for complaint, for many reasons might arise where the accumulation of that amount might be legally impossible, but he may properly protest against the voluntary abandonment of the project without his consent, and on that ground rescind. It is true that he consented to the abandonment of the first plan, but conditionally, and upon the failure to perform the promised conditions his original consent was without consideration and could be revoked, and be restored to his original status.

In the Matter of Bond and Mortgage Guaranty Company, 271 N. Y. 545, 3 N. E. (2) 591.

"The Bond and Mortgage Company was in rehabilitation, not in liquidation. There is a marked distinction. In Rehabilitation, there are no claims to be presented and allowed. In liquidation, claims liquidated or contingent must be presented within a certain designated time."

In the Matter of Lawyers Mortgage Company, 163 Misc. Rep. 680, 298 N. Y. S. 88.

"No reorganization can be accomplished in the pending Rehabilitation proceeding, in view of the fact that sections 424 and 425 of the Insurance law for the filing and proof of claims apply only to liquidation proceedings. Only through a liquidation proceeding can the company be freed from unknown and unpresented claims. Unless 100% of the stockholders and creditors agree to a plan it is clear that provisions must be made to protect the rights of nonassentors."

In re International Milling Co., 259 N. Y. 77, 18 N. E. 54.

"As the bank was the bailee and not a debtor as to the fund in question, there can be no doubt as to the petitioner's right under the Section to claim a preference. To hold that the Section excludes petitioner from claiming the Identical fund in question as bailor would, in the event the assets should prove to be insufficient to meet the claims of preferred creditors, amount to a confiscation of his property without due process of law. Such a construction would make the statute unconstitutional, and is unnecessary because the statute contains no words which evidence an intent to exclude existing remedies.

In Maloney v. Rhode Island Insurance Company, 251 Pac. (2) 1027, 115 C. A. (2) 238, it was held that a conservatorship court does not have jurisdiction to bring into pending conservatorship proceeding by mere order to show cause, persons who are not parties to conservatorship, and who assert independent claim of ownership to assets in their possession.

Udangen v. Edwards, 174 N. W. 769, 187 Ia. 1005.

"The plaintiff asked for an accounting. He was bound in equity to make an accounting himself. Under his contract, he was to pay the defendant 10% of the profit. He never paid him any profits, and never made any statement concerning profits. There was no data in the hands of Edwards from which profits could be estimated. The plaintiff alone knew what he paid for the bankrupt stocks. He alone received the trade discounts. We think it was incumbent upon him in equity to disclose the amount of profits due him from Edwards, and to tender it as a credit upon any amount found due him from Edwards. The inference arises quite naturally that his unwillingness to disclose his profits was the reason for his failure to produce his books."

41-3504. Grounds for Rehabilitation.—The commissioner may apply for an order directing him to rehabilitate a domestic insurer upon one or more of the following grounds: That the insurer

(a) is insolvent; or,

(i) has consented to such an order through a majority of its directors, stockholders, members, or subscribers; or,

41-3505. Order of Rehabilitation—Termination.—1. An order to rehabilitate a domestic insurer shall direct the commissioner forthwith to take possession of the property

of the insurer and to conduct the business thereof, and to take such steps toward removal of the causes and conditions which have made rehabilitation necessary, as the court may direct.

2. If at any time the commissioner deems that further efforts to rehabilitate the insurer would be useless, he may apply to the court for an order of liquidation.

3. The commissioner, or any interested person upon due notice to the commissioner, at any time may apply for an order terminating the rehabilitation proceeding and permitting the insurer to resume possession of its property and the conduct of its business, but no such order shall be granted except when, after a full hearing, the court has determined that the purposes of the proceedings have been fully accomplished.

41-3510. Conduct of Delinquency Proceedings Against Insurers Domiciled in This State.—1. Whenever, under the laws of this state, a receiver is to be appointed in delinquency proceedings for an insurer domiciled in this state, the court shall appoint the commissioner as such receiver. The court shall direct the commissioner forthwith to take possession of the assets of the insurer and to administer the same under the orders of the court.

2. As domiciliary receiver, the commissioner shall be vested, by operation of law, with the title to all property, contracts, and rights of action, and all of the books and records of the insurer wherever located, as of the date of entry of the order directing him to rehabilitate or liquidate a domestic insurer, and he shall have the right to recover the same and reduce the same to his possession.

5. Upon taking possession of the assets of an insurer, the domiciliary receiver shall, subject to the direction of the court, immediately proceed to conduct the business of the

insurer or to take such steps as are authorized by the laws of this state for the purpose of liquidating, rehabilitating, reorganizing, or conserving the affairs of the insurer.

41-3512. Injunctions.—1. Upon application by the commissioner for such an order to show cause, or at any time thereafter, the court may, without notice, issue an injunction restraining the insurer, its officers, directors, stockholders, members, subscribers, agents, and all other persons from the transaction of its business or the waste or disposition of its property until the further order of the court.

2. The court may, at any time during a proceeding under this act, issue such other injunctions or orders as may be deemed necessary to prevent interference with the commissioner or the proceeding, or waste of the assets of the insurer, or the commencement or prosecution of any actions, or the obtaining of preferences, judgments, attachments or other liens, or the making of any levy against the insurer or against its assets or any part thereof.

41-3507. Order of Liquidation.—1. An order to liquidate the business of a domestic insurer shall direct the commissioner forthwith to take possession of the property of the insurer, to liquidate its business, to deal with the insurer's property and business in his own name as Commissioner, or in the name of the insurer as the court may direct, to give notice to all creditors who may have claims against the insurer to present such claims.

41-3523 provides that upon granting an order of liquidation, the Insurance Commissioner shall notify all persons who may have claims against the insurer to file them within four months of the time of the entry of such order.

No. 18226

United States Court of Appeals

FOR THE NINTH CIRCUIT

MORTON K. LANGE,

Appellant & Cross-Appellee,

vs.

LIBERTY NATIONAL INSURANCE COMPANY,

Appellee & Cross-Appellant.

BRIEF OF APPELLEE AND CROSS-APPELLANT

On Appell from the District Court of the United States for the District of Idaho, Northern Division

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H. S. SANDERSON
of McNAUGHTON & SANDERSON

Residence: Coeur d'Alene, Idaho.
Counsel for Appellee & Cross-Appellant.

INDEX

TABLE OF CASES CITED

TABLE OF CASES CITED, Cont.

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Statement of Jurisdiction.

We agree with the appellant's statement of the jurisdiction of the District Court and this Court. As stated in the pre-trial order, this is a suit between a citizen and resident of Missouri, the plaintiff, and an Idaho corporation, the defendant, where the amount in controversy exceeds the sum of $10,000.00 exclusive of interest and costs.

The suit was originally commenced in the Circuit Court of the City of St. Louis, State of Missouri, jurisdiction being based on an attachment and garnishment levied against the Transatlantic Casualty Underwriters, Inc., a corporation of the State of Missouri, Eastern Division, on ground of diversity of citizenship. Thereafter upon defendant's application the venue was ordered changed on the United States District Court for the District of Idaho, Northern Division, the district of defendant's residence.

STATEMENT OF CASE

Since the appellant, Morton K. Lange, has in his brief, referred to the parties as plaintiff and defendant, this appellee and cross-appellant will do likewise for reasons of consistency and clarity.

Plaintiff's statement of the case consists principally of his summation of what is contained in the respective pleadings of the parties, which this defendant submits is not wholly accurate and of a misleading statement of the evidence. Consequently, defendant deems it necessary in order for this court to obtain a clear picture of this litigation to enlarge said statement by setting forth the material and undisputed facts of the controversy, all as reflected by the pre-trial order herein or the transcript of the evidence, as follows:

That the plaintiff, an attorney, as the result of his military and civilian employment in Germany following the war, saw an opportunity to write automobile public-liability insurance for American servicemen there and in pursuance thereof, did learn of and negotiate a general agency agreement for that purpose with the defendant, a small Idaho insurance corporation, with its' principal office at Coeur d'-Alene, Idaho (Tr. pp. 3-10, Ex. 3 & 4). The result was that a managing general agency agreement was entered into on September 1, 1955, between defendant Company and Transatlantic Casualty Underwriters, Inc., a Missouri corporation that the plaintiff formed for the purpose of doing such agency business (Tr. pp. 10, 143, 145). Said agency agreement provided, amoung other things, for agents' commission of 30% or more, that it was determinable by either party

upon notice and that all premiums collected were property of the defendant and commissions to the agent thereon merely debts of defendant (Ex. 1). In the Fall of 1956, defendant sought to reduce the commission to 20% on the grounds that the losses on the Germany business were high and the business therefor unprofitable for defendant. (Tr. pp. 24-26, 148-149, 296, 259, Ex. 8).

That due to its impaired capital condition (Ex. 10) the defendant's operations were taken over on Sept. 24, 1956, by the State of Idaho Insurance Department, pursuant to an order duly entered on said date by the District Court of the Eighth Judicial District of the State of Idaho, in and for the County of Kootenai in the matter of the rehabilitation of defendant, and which order enjoined the officers and directors of defendant from taking any action with respect to defendant's affairs except with written permission of the Rehabilitator. (PTO p. 18, Ex. 14). Mr. B. J. Albertson took active charge of defendant's operation as Deputy Rehabilitator under the Idaho Insurance Commissioner (Tr. pp. 322-323, P. T. O. p. 17). That at a meeting on December 10, 1956, the then stockholders of defendant passed a resolution reducing the par value of defendant's stock from $100.00 to $5.00 and thereby increasing their outstanding stock from 3,000 shares to 60,000 and further turning the same over to the Rehabilitator for the sale, under a plan then adopted, of not more than 36,000 of said shares at $7.75 per share on or before January 2, 1957, the proceeds of which were to be donated to the defendant's treasury, and the unsold balance of said stock, after allowing the old stockholders for their interest one share for every nine

sold, to become treasury stock of defendant. Mr. J. Henry Bell, of Coeur d'Alene, Idaho was appointed to act as trustee for the stockholders in the sale of such stock (P. T. O. pp. 18-19, Ex. 11).

That upon learning that defendant was in rehabilitation, the plaintiff hastened to Coeur d'Alene from Germany, arriving on December 12, 1956, and remained there until the 22nd when he left for Minneapolis, and just prior to leaving he gave Mr. Albertson a check in the amount of $50,000.00 payable to said trustee and also a promissory note for another like amount, due in February of 1957, also payable to said trustee, pursuant to said contemplated refinancing arrangement (P. T. O. 19, tr. pp. 29-30). Plaintiff returned to Coeur d'Alene on January 2, 1957, at which time negotiations between he and Mr. Albertson resumed (P. T. O. 20, tr. p. 50). Plaintiff was joined in Coeur d'Alene on January 2nd, 1957, by Mr. Luther Smith of St. Louis, his attorney and business associate, who stayed with him until after plaintiff had negotiated for and made his investment in defendant's stock (tr. pp. 278-298). On January 6, 1957, Mr. Albertson informed plaintiff that his said note wasn't acceptable to the Idaho Insurance Department in connection with the financing proposal then being considered; that next day plaintiff presented Mr. Albertson with a letter (Ex. 13), requesting return of his check and note and advising that he would be willing to subscribe to $50,003.00 worth of defendant's stock under conditions set forth in said letter (P. T. O. p. 20). Then on the next day, January 8, 1957, plaintiff informed Mr. Albertson that he was willing to subscribe the same amount provided the defendant would be operated under the joint control

of its' Board of Directors and the Rehabilitator and provided a satisfactory agency contract for a period not less than one year be given to Transatlantic Casualty Underwriters, Inc. On that day, Mr. Albertson made application to and obtained from the court an order modifying the previous rehabilitation order by providing that the affairs of defendant would be jointly managed by the Rehabilitator and the Board upon filing evidence that the defendant had not less than the statutory paid in capital of $100,000.00. Mr. Albertson agreed with plaintiff to file such evidence as soon as the amount subscribed under the minimum financing proposal had been paid in (P. T. O. pp. 20-21).

At a special meeting of defendant's Board of Directors on January 8, 1957, plaintiff was appointed as a Director to fill one of the vacancies caused by resignation and was at a meeting on the following day, appointed as President of defendant (P. T. O. p. 21).

On or about January 11, 1957, the plaintiff as president of defendant sent out a letter (Ex. 15) to all stock subscribers advising them that a sufficient amount had been subscribed to meet the statory requirement for paid in capital and permit continued operation of defendant, that a change in plans was necessary and that the time for stock subscription had been extended to March 15, 1957, that any subscribers not agreeable thereto could obtain their money back if they requested same not later than January 18, 1957. Waiver of notice was enclosed for the use of subscribers in assenting to said extended time (P. T. O. p. 21, Ex. 15). At the same time, plaintiff also signed a letter to defendant's agent informing

them that the first steps in Rehabilitation has been taken (Ex. 15) and on or about January 14, 1957, plaintiff signed a document setting forth his management recommendations for defendant. (P. T. O. p. 21).

On January 11, 1957, amendment No. 1 to the Managing General Agency Agreement between defendant and Transatlantic Casualty Underwriters, Inc., was executed, providing that the agency commissions be from 27½ to 30%, that the agreement remain in force at least until the end of 1957, granting the agent additional time in which to pay monies over to defendant and authorizing the agent to write insurance in additional countries (P. T. O. pp. 21 & 22, Tr. pp. 209-212, Ex. 1). Thereupon, on said date, plaintiff executed a stock subscription agreement and the waiver aforementioned and gave his check in the amount of $50,000.00 to said trustee (P. T. O. p. 22).

The source of the money upon which said check was drawn was Transatlantic Casualty Underwriters, Inc., which company was then indebted to defendant for premium monies collected but not remitted (Tr. pp. 208 & 209, 321,), although plaintiff previously assured Mr. Albertson that it was his own money (Tr. p. 337).

The plaintiff left Coeur d'Alene for Germany on January 14, 1957, intending to return about March 1st to assume the management of defendant. At the time he left he was given a document by Mr. Albertson (Ex. 17), setting forth conditions to be realized prior to termination of rehabilitation (P. T. O. p. 22, Tr. pp. 214 & 374).

Pursuant to meetings held by the Commissioner of Insurance and Mr. Albertson with officers and employees of defendant to ascertain whether the defendant could survive with the minimum financing then on hand and the consensus being in favor, the Commissioner and his said Deputy decided to accept the same and thereupon the trustee was directed to turn the money in his possession over to defendant, which he did on January 18th and 21st, 1957. Said money was spent by defendant. (P. T. O. p. 22, tr. pp. 340-341).

Plaintiff was informed by Mr. Albertson that the Idaho Attorney General had ruled that the defendant couldn't be released into joint control until the Rehabilitator could "guarantee" to the court that the $100,000.00 capital was unimpaired. No such "guarantee" was ever filed with court and the defendant was never formally released into joint control (P. T. O. pp. 22 & 23).

On or about January 6, 1957, a Mr. Frank Becker and his associates commenced negotiations with Mr. Albertson, which led to a decision on their part in March, 1957, to purchase all the remaining outstanding unsold shares of defendant's stock, provided they could secure the same and thereby obtain a controlling interest. (P. T. O. pp. 23 & 24). The plaintiff communicated with Mr. Becker relative to such purchase and wired him that he wouldn't oppose such sale if the other stockholders favored it (Tr. pp. 84-90, 240-244, Ex. 25).

In the latter part of March, 1957, after the deadline for securing stock subscriptions had expired, the old stock holders who made their stock available for

rehabilitation purposes, determined to take 2,162 shares as their full share and to sell all of the unsold balance of the 60,000 shares, i. e. 38,377 shares for $7.75 per share, all the proceeds to go to defendant and they consummated an agreement for the sale thereof to Mr. Becker and associates, by and with the consent of the Rehabilitator (P. T. O. pp. 24 & 25, Ex. 24).

On or about March 30, 1957, the plaintiff, as President of defendant, executed stock certificates for the stock subscribed by plaintiff and others prior to March 15th, 1957, and sent them to the defendant's Secretary. (P. T. O. p. 25).

On April 5, 1957, a notice was sent to all stockholders of defendant, including plaintiff, advising them of the latest refinancing plan and requesting them to deliver a consent and waiver to defendant. All of the Stockholders delivered such a waiver except plaintiff, although he did sign one (P. T. O. p. 26, tr. p. 244). At the annual meeting of stockholders of defendant on April 15, 1957, the stockholders unanimously approved the stock sale to Mr. Becker and associate and further approved all acts of the Insurance Commissioner and defendant's officers in proceedings under rehabilitation. The plaintiff, who was still President, was given due notice of that meeting but didn't attend (P. T. O. p. 26, Ex. 29, Tr. pp. 95 97).

On May 16, 1957, Mr. Albertson, the acting Rehabilitator, filed with the Idaho District Court, an application for termination of the rehabilitation and on the same day an order was entered fixing the hearing thereon for May 28, 1957 and directing Mr. Al-

bertson to give at least five (5) days notice thereof to all stockholders by mail and publication, which notice was duly given (P. T. O. pp. 27 & 28). At said court hearing, which was wholly unopposed, a Judgment and Order terminating said rehabilitation proceeding was entered (P. T. O. p. 27).

STATEMENT OF DEFENDANT'S CROSS-CLAIM

It is admitted that the Transatlantic Casualty Underwriters, Inc. has collected insurance premiums on behalf of the defendant in Germany which it has refused and still refuses to pay over to the defendant in the amount of $49,297.58. In this action, the defendant cross-claimed against the plaintiff to collect the same, alleging and contending that even though said Missouri corporation is not a party to this action, it is simply the alter ego or instrumentality of the plaintiff to carry on said agency business and that therefore said corporate entity should be disregarded—also that plaintiff while in a position of trust and confidence for the defendant, did cause said premium monies of the defendant to be accumulated and withheld by said Transatlantic Company, so that plaintiff could levy an attachment thereagainst when he intiated this law suit in the Missouri court.

The plaintiff denies the allegations of the cross-claim, and claims that the Transatlantic Company has various off-sets, credits and counter-claims against the defendant, which make said corporation an indispensable party.

The facts are that the plaintiff caused the formation of Transatlantic Casualty Underwriters, Inc., a Missouri corporation, to enter into the general agency

agreement with defendant (Tr. p. 10, 143). Plaintiff at all times owned all of said corporation stock except for one share each owned by his wife and Mr. Luther Smith, and plaintiff was at all times the president and manager thereof (Tr. pp. 145 & 147). Said company represented only the defendant (Tr. p. 147). The plaintiff individually gave a fidelity bond to defendant at the inception of relationship which wasn't renewed after plaintiff became president of defendant (Tr. pp. 144, 362-364). The plaintiff, at his request, was authorized to draw checks against the bank account of defendant in Germany, for the payment of claims (Tr. pp. 22-23, 263).

The $50,000.00 that the plaintiff purchased defendant's stock with was actually money belonging to the Transatlantic Casualty Underwriters, Inc. (Tr. p. 321) which company at the time was indebted to the defendant for premium monies in the amount of approximately $75,000.00 (Tr. pp. 168), that representing most all of its cash on hand and at that time (Tr. p. 260). Plaintiff made such investment in order to save and protect the business of Transatlantic Company and thereby protect himself from criticism, bad publicity and financial loss. (Tr. pp. 160-162, 357).

The evidence shows that plaintiff attempted to largely condition his investment on benefits that would accrue to his Transatlantic company, i. e., a new contract for a minimum term at better commission rates and an extension of time in which to pay premiums collected over to the defendant (Tr. pp. 209-211, Ex. 1 & 13).

The plaintiff caused the Transatlantic Company

to withhold payment of premium monies to defendant for the purpose of accumulating a fund that he could attach in Missouri for jurisdictional reasons in this personal suit against defendant (Tr. pp. 254-255, 360-361). Although such attachment was never supported by plaintiff's bond as required by law and therefore became automatically terminated, said premium monies have never been remitted to the defendant (Tr. pp. 254-255) despite the fact that the agency agreement provides that all premiums are property of defendant and commissions of the agent thereon are merely debts of defendant and the agent guarantees the premium on all policies issued (Ex.1).

The trial court upon findings that the said Transatlantic Casualty Underwriters, Inc., was an entity separate and apart from plaintiff and was not a party to this action, decreed the dismissal of defendant's cross-claim against plaintiff.

SPECIFICATIONS OF ERROR

I.

The trial court erred in finding that the Transatlantic Casualty Underwriters, Inc., a Missouri corporation, is an entity separate and apart from the appellant and cross-appellee, Morton K. Lange, and in concluding therefor that cross-appellants counterclaim against said corporation for an accounting and to recover insurance premium monies admittedly withheld by it should be dismissed, because said corporation is not a party to this action, instead of finding that said corporate entity should be disregarded because it is merely the alter ego of the appellant and cross-appellee Morton K. Lange, and concluding

that cross-appellant is entitled to appropriate equitable relief on its' said counterclaim.

SUMMARY OF ARGUMENT

I.

The findings of the trial court were sufficiently comprehensive and pertinent to the issues to provide a basis for the court's decision and were supported by the evidence—they therefore sufficiently comply with the requirements of Rule 52(a) of the Federal Rules of Civil Procedure.

II.

The findings of the trial court, being supported by substantial evidence and none thereof appearing to be plainly erroneous, will not be overturned on review.

III.

That plaintiff should have made his claim in the State Court, and the judgments of the state court approving the confirming facts all acts of the Rehabilitator and terminating the rehabilitation proceedings is binding and conclusive upon plaintiff. Plaintiff had the express statutory rght to a hearing and had actual notice of such right, so the requirement of procedural due process is satisfied. The plaintiff cannot now challenge that judgment in this court.

IV.

The essential elements of an action for fraud and deceit are not present. The factual matters alleged

to have been misrepresented were not false or known to be false by the party making it, and the other matter alleged to have been misrepresented were not facts. The plaintiff did not, in fact, rely on any representations made by Mr. Albertson or Mr. Chapman, whether true or false.

V.

Plaintiff waived his right to sue for damages or rescind for fraud by reason of his inconsistent conduct and dealings with property after knowledge. Also, as a condition of rescinding, the plaintiff has never offered to, has not and cannot put the defendant in its' former position.

VI

The evidence entitles the defendant to recover from the plaintiff the premium monies in the amount of $49,297.58, admitted to be withheld by the Transatlantic Casualty Underwriters, Inc., on the grounds that said corporation is and was merely the alter ego or business conduit of the plaintiff. The corporate entity should be disregarded under the facts and circumstances.

A R G U M E N T

I.

The defendant submits that the trial court's findings of fact states the ultimate relevant facts necessary to support the ultimate conclusions reached by the court, and that such findings are therefore in compliance with Rule 52(a) of the Federal Rules of Civil Procedure.

The ultimate test as to the adequacy of findings will always be whether they are sufficiently comprehensive and pertinent to the issues to provide a basis for decision and whether they are supported by the evidence.

Summerbell v. Elgin Nat. Watch Co. (CADC) 215, F. 2d. 323.

Shapiro v. Rubens (CAA Ind.) 166 F. 2d. 659.
Weber v. McKee (CA Texas) 215 F. 2d. 447.

"Findings should not be discursive; they should not state the evidence or any of the reasoning upon the evidence; they should be categorical and confined to those propositions of fact which fit upon the relevant propositions of law."

Petterson Lighterage & Towing Corp, v. New York Central R. Co. (CAA 2d.), 126 F. 2d. 992.

II.

It is the contention of the plaintiff, as presented by his Points on Appeal Nos. II-IX, that the trial court erred in finding from the evidence introduced that plaintiffs subscription monies were turned over to the defendant pursuant to plaintiff's agreement, full knowledge and consent, that no fraud whatever was practiced upon plaintiff for the purpose of inducing his subscription or at all, nor was any agreement made with plaintiff violated by defendant taking and retaining such monies and in further finding inequitable and estoppel producing actions and conduct or ommissions on the part of plaintiff. Defendant submits that each and all of the trial court's findings are supported by substantial, although in some

instances conflicting evidence and that therefore said findings are entitled to be affirmed on this appeal, particularly so, since this is an equity matter.

The substantial and convincing evidence in support of the court's finding is as follows:

That when it developed that a sufficient amount of new financing, satisfactory to the Insurance Commissioner, had not been subscribed by January 2nd, 1957, to meet the minimum financing requirements as originally contemplated, the December 10th, 1956 resolution and stock subscription agreement was necessarily modified (Tr. pp. 336, 339-340, Ex. 15) a few days after January 2nd, 1957, to provide that the minimum financing of approximately $275,000.00 that the original plan contemplated raising by January 2nd, be undertaken in two stages, to-wit: (a) that the financing to provide at least the minimum capital required by law for the Company to continue in business after December 31st, 1956, be immediately accomplished and taken into the Company (Tr. pp. 183-185, 338-340, 354-356, Exs. 15 & 16, and, (b) that the time be extended until March 15th, 1957, from January 2nd for selling the unsold balance of the 36,000 shares, to raise the minimum capital satisfactory to the Commissioner for ending the rehabilitation proceedings (Tr. pp. 339-340).

On or about January 8th, 1957, the plaintiff, as a condition of his later stock subscription, had arranged to have himself appointed to defendant's Board of Directors, and then made President of the defendant, which positions also presumed that he would be a stockholder (Tr. pp. 208, P. T. O. p. 21). Thereafter, on January 11th, 1957, an amendment to

the Agency contract between plaintiff's Transatlantic Casualty Underwriters, Inc., and the defendant, of which plaintiff was then president, was executed (Tr. pp. 209-211) which guaranteed the agency relationship for another year at higher commissions over what defendant felt obliged to reduce them to in October, 1956, extended the time for premium remittance, and authorized the writing of insurance in France, Spain and Italy, but significently omitted any provision for the "green cards and excess limits facilities", which plaintiff, an attorney, contends were of such vital importance (Tr. pp. 209-212, Ex. 1). Thereupon, the plaintiff made his stock subscription for $50,000.00 (P. T. O. pp. 21 & 22, Ex. 16), using for that purpose monies of Transatlantic Company, which company was then indebted to the defendant for more than that amount (Tr. pp. 168, 208-209). He intended to thereby become a stockholder in defendant and did (Tr. p. 207). It was most important to plaintiff that the defendant survive and continue to operate (Tr. pp. 160-162, 207, 357), and he knew that he had to put that amount of money in or the defendant would have been liquidated (Tr. pp. 202-203).

On January 11th also, the plaintiff as President of the defendant, sent out a letter to all subscribers advising them that sufficient subscriptions had then been received to provide the statutory *paid in* capital of $100,000.00 and permit the defendant to continue to operate but that additional financing was necessary and that the original agreement had been modified so as to extend the time for subscriptions to March 15th, 1957, and that present subscribers could obtain their money back if they requested the same

not later than January 18th, 1957 (Ex. 15), and he also on that date sent a letter to defendant's agents advising that the first steps in rehabilitation of defendant had been accomplished and that the impairment of capital had been sufficiently relieved to permit defendant to continue to operate (Ex. 15).

Plaintiff was informed prior to January 18th that the defendant was critically short of cash with which to meet its' normal operating expenses not to mention payment of claims (Tr. pp. 340-341, 355-356).

On January 18th and 21st, 1957, promptly following the expiration of time in which subscribers could obtain their money back pursuant to plaintiff's notice to them of January 11th (Ex. 15), the subscription money then on hand, about $150,000.00 was turned over to the defendant by the trustee at the direction of the Rehabilitator (P. T. O. p. 19, Tr. pp. 339-340). While plaintiff incredably denies that he had knowledge that such was going to happen, he does, however, admit to receiving knowledge on or about February 1st, 1957 that his and the other subscribers' money had gone into the defendant's treasury (Tr. pp. 71-72, Ex. 18, 19, 52).

Contrary to plaintiff's statement on p. 25 of his brief, defendant's answer does not admit that the funds transferred to the defendant were insufficient to meet the requirements of the Commissioner for the continued operation of the company, but rather does admit that funds were transferred to the defendant on or about January 19th, 1957, and further admits that sufficient funds were not raised by the resale of stock by March 15, 1957, to meet the requirements of the Insurance Commissioner to permit the

continued operation of the defendant (P. T. O. p. 5). The funds transferred to the defendant in January, 1957, were not only necessary but sufficient to provide the statutory minimum capital and thereby save defendant from liquidation but to permit its' continued operation and by reason thereof the defendant at all times since has been able to continue operating (Tr. pp. 358-359). The very exhibits cited by plaintiff (Exs. 38, 39, 42 & 46) do show, despite plaintiff's contrary assertions, that the amount of money turned over to defendant did not only make the assets equal to the liabilities as of that time, but did also provide the required minimum capital of $100,000.00 (Tr. pp. 326, 339-340). By the end of March, 1957, however, the defendant's capital was again impaired due to further losses (Tr. pp. 121-122, Exs. 36 & 38), and the amount of additional money raised as of that time was not sufficient to meet the requirements for continued operation (Exs. 20, 21, 22 & 28). It was always recognized by the Rehabilitator and plaintiff was advised that the defendant should have at least $250,000.00 additional financing (Tr. p. 159), the original plan called for raising $279,000.00 (Tr. pp. 44-45, Ex. 11) and $500,000.00 was really needed (Tr. p. 340).

In the month of March, 1957, the plaintiff as president, signed and transmitted to the secretary of defendant the stock certificates representing the stock subscribed by himself as well as the numerous other subscribers through the trustee (P. T. O. p. 25

Tr. p. 358), all of which others presumably understood the circumstances of their investment and have never questioned the same whatever (Tr. p. 25).

An understanding was reached between plaintiff and Mr. Albertson that state court rehabilitation order would be modified to allow for joint management of defendant by the rehabilitator and the board of directors, and an application was made to the court for the purpose (P. T. O. p. 20, Ex. 14). It wasn't accomplished because the Idaho Attorney General informed Mr. Albertson that he would have to guarantee to the court that defendant had unimpaired the capital required by statute as a condition thereof (Ex. 19). It would appear to be very questionable whether the statutory Rehabilitator could lawfully delegate or impair performance of his duties by such an arrangement and as a practical matter, if under joint control there was lack of agreement, the decision of the rehabilitator would doubtless control (Tr. pp. 215-217). Actually, the Board and Mr. Albertson did meet and work together to try and resolve defendant's troubles (Tr. p. 347, Exs. 18, 19 & 20). The plaintiff, who was president and a director of defendant, was, however, absent in Germany at all times (Tr. p. 216).

The plaintiff and his attorney, Mr. Smith, had every opportunity to make their own investigation and examination of defendant's condition and affairs during most of a month prior to plaintiff making his investment (Tr. pp. 165-167, 50 & 68), did make inquiries and had the same information that Mr. Albertson had (Tr. 327,328, 342-343, Ex. 10).

Mr. Albertson, the Rehabilitator, testified that he believed everything he told plaintiff to be true, that he never since learned of anything told to plaintiff that was untrue, that he had no reason to deceive

him or to induce him to purchase defendant's stock (Tr. p. 335), and that he made no attempt whatever to and didn't deceive the plaintiff (Tr. pp. 342-344). Mr. Chapman, who plaintiff also claims made misrepresentations to him, was a Vice-President of defendant and as such was simply an employee under Mr. Albertson during rehabilitation. The court rehabilitation order divested him of all authority on behalf of the defendant and he had no authority from Mr. Albertson to make any representations to plaintiff (Tr. pp. 344-345). According to Mr. Albertson, plaintiff's investment was prompted by Mr. Albertson's matter of fact representation to him that the defendant would be liquidated unless there was a minimum amount of capital in it by the end of 1956. (Tr. p. 344).

Mr. Albertson further testified that in truth the defendant's assets did equal or exceed its' liabilities as of December 31st, 1956, and that a net operating profit was made for that year, which facts are reflected by the financial statement (Tr. pp. 334-335, Ex. 37). Admittedly, in insurance accounting, there are, as of any one time, a number of items which can only be carefully estimated, and the accuracy of which cannot be known until a couple of months later. For that reason, it is impossible to make an absolute representation as to the present financial condition of such a company (Tr. pp. 329-331). That fact was known to plaintiff (Tr. pp. 223-224). The plaintiff was unable to show by his testimony that the defendant's assets weren't equal to its' liabilities on December 31st, 1956, as he alleged (Tr. pp. 217-222).

The plaintiff, better than anyone, should have

known about the accuracy of some important items in the financial report, for it later developed that it was his own German agency business that occasioned substantial losses for the defendant in 1956 (Tr. pp. 224-225, Ex. 20). Plaintiff's agency business never was profitable for defendant and from January, 1957, to the termination of the relationship in 1959, it caused losses of more than $100,000.00 for defendant (Tr. p. 359).

Mr. Albertson testified that he never agreed to any of the conditions advanced by plaintiff for putting his money in because as Rehabilitator, he was not in any position to do so and was not involved in the sale of defendant's stock—that was the responsibility of the owners and managers of defendant and the Rehabilitator only approved or disapproved of their actions (Tr. pp. 342 & 344).

As for the matter of "green cards and excess limits", the evidence discloses that the plaintiff had "green card" facilities at nearly all times (Tr. pp. 239-240, 314, 373) that the defendant's management made diligent efforts to obtain the cards through another source in order to please plaintiff, but that the furnishing of both cards and excess limits were not within the control of defendant for it had to rely on some reinsurer to provide the same (Tr. pp. 138-140, 238, Ex. 38). Plaintiff as President of defendant, carried on his own negotiations for a change in "card" arrangement (Tr. p. 239).

Plaintiff now contends that his rights were greatly violated because the stock remaining unsold on March 15th, 1957, was later sold by the original stockholders of defendant to the Becker Group rather than

returned to the defendant and cancelled. The facts of the matter are that the plaintiff, who was President of defendant and charged with its' welfare, knew that as of March 16, 1957, the defendant required a substantial amount of additional financing if it was ever to continue operating, let alone get out from under the rehabilitation proceedings (Ex. 21), that the Becker Group was negotiating in good faith to purchase all of the unsold and remaining stock from the old stockholders (Tr. p. 243, Ex. 22) and in fact plaintiff had been soliciting and encouraging the Becker Group for weeks past (Tr. pp. 240-241).

Plaintiff had full knowledge of the proposed purchase by the Becker Group when he executed the stock certificate for himself and others who had purchased through the trustee, and was relying upon such refinancing (Ex. 23). Plaintiff even sent a telegram to Mr. Becker on April 7, 1957 (Ex. 25) stating that he had no objections to his Group buying the remaining 38,000.00 shares and that they need expect no trouble from plaintiff if other stockholders in favor—which all others were (Tr. pp. 243-244). Like all the other existing stockholders, he signed a consent and waiver, but for some unknown reason it was never delivered to the defendant (Tr. p. 244). Pursuant to such indicated approval an option was taken on all of said stock by the Becker Group on March 27, 1957 under which the purchase was conditioned on sufficient approval by the defendant's stockholders and of the state court at a hearing terminating the rehabilitation (Ex. 24).

At a special meeting of defendant's stockholders held on April 15, 1957, of which plaintiff was given

due notice, the stockholders present unanimously approved said sale (P. T. O. p. 26). The plaintiff's stock was not voted thereat. He testified that he wouldn't have objected thereto (Tr. pp. 95-97).

The defendant submits that even if said stock had been cancelled as plaintiff claims it should have been, it would have become either treasury or unissed stock of the defendant, in which case it was subject to issuance or sale by the management of the defendant for necessary financing purposes just as was done. There was certainly no commitment made by or on behalf of the defendant that its' Board of Directors would no longer have any authority to take such action as it considered necessary for the best interests of the defendant.

Pursuant to said stock option agreement and the stockholder approval, the Rehabilitator filed a petition with the state court for a final hearing relative to termination of the rehabilitation proceedings and approving the actions of the deputy rehabilitator, Mr. Albertson, with respect thereto, and the hearing thereon was fixed for May 28, 1957, of which due notice was received by the plaintiff (P. T. O. Tr. p.. 244, pp. 26 & 27). Despite the fact that the plaintiff had been making charges of fraud against the Rehabilitator since about aMrch 1, 1957, or sooner and had knowledge since about February 1, 1957, that his money had been taken into the defendant, he never at any time informed the Becker Group prior to said Group's large investment in the defendant in May of his fraud claims against the defendant (Tr. pp. 250-251).

The plaintiff did not intervene in any manner

whatever in said court proceeding to terminate the rehabilitation of defendant and was not present at the final hearing (Tr. pp. 245-246, Ex. 65). Prior thereto, however, the plaintiff had engaged an attorney to look into the matter of the alleged fraudulent stock sale to the Becker Group (Tr. pp. 244-245).

There being no objections made by any person whatever, to the proposed termination of rehabilitation proceedings (Tr. p. 349) and the state court finding that the defendant, upon the investment of the Becker Group, would have adequate and unimpaired capital and surplus, entered its' decree on May 28, 1957, terminating the rehabilitation proceedings (Ex. 65). On that same day the Becker Group invested approximately $300,000.00 in defendant's stock, all of which amount went into defendant's treasury (Tr. pp. 351, 372, Ex. 24). The Rehabilitator wouldn't have recommended that the defendant be discharged without the investments of plaintiff, the Becker Group and the other subscribers (Tr. pp. 246 & 350). By the same order, the court approved all actions of the Rehabilitator during the proceedings (Tr. p. 349, Ex. 65).

The plaintiff testified that he was willing to retain his stock in defendant and go along with the Becker management of defendant (Tr. p. 349, 252), later he wanted the Becker Group to buy him out (Tr. pp. 246-247), and then he made his first demand upon defendant in August 1958, to return his investment (Tr. p. 252). Plaintiff voted his stock at a special stockholder's meeting of defendant in November, 1957 (Tr. p. 253). In late 1957, and before the plaintiff made any demands for return of his money, the

Becker Group invested an additional $250,000.00 in the defendant, for which they took contribution certificates (Tr. pp. 129-130, 251, 253, Ex. 34).

The relationship between defendant and plaintiff's agency company was continued until June, 1959, when it was terminated by plaintiff's agency (Tr. 137 & 142), after many threats of a law suit by plaintiff (Tr. p. 360).

There are no allegations in this case, nor could there be any, that any of the investors who invested in the rehabilitation of this defendant company, in the amount of approximately $750,000.00, were anything but completely innocent investors. Indeed the plaintiff, who took on the role of President and Chairman of the Board of defendant, and thereby had a duty to investigate and know the condition of defendant is perhaps the least innocent of any of these various investors. Even after he had made some claims of being defrauded, he signed his own stock certificate and those of other members of his group, which other members invested about one hundred thousand dollars.

The broad picture of this lawsuit from an equity standpoint, is the picture of one person who invested $50,000.00 of a group of people who invested about $750,000.00, asking to get his whole investment returned to him at the expense of numerous other completely innocent investors, some of whom relied to some extent on him in making their investment, and which person, without any objection, allowed the court to enter an order approving the acts of the Rehabilitator.

Under all the facts and circumstances, the trial court decided that if there was any fraud or wrongdoing, the plaintiff was a party to it (Tr. pp. 381 & 383).

The trial court's findings, supported by substantial evidence, and not appearing to be plainly erroneous, must stand on appeal.

Wight v. Chandler, (CCA Wyo.) 264 F. 2d. 249.
Arn v. Dunnett (CCA Okla.). 93 F. 2d. 634, Cert. den 58S. Ct. 1046; 304 U. S. 577, 82 L. Ed. 1540.

Findings of fact by trial judge on conflicting evidence are entitled to great weight.

Nenkom v. North Butte Min. Co. (CCA Mont.) 84 F. 2d. 101.
Hedrick v. Perry (CCANM) 102 F. 2d. 802.

Findings of fact made in an equity case are presumptively correct and will not be disturbed unless a serious mistake has been made in consideration of the evidence.

Hedrick v. Perry, (CCANM) 102 F. 2d. 802.
Chisholm v. House, (CCA Okla.) 183 F. 2d. 698.
Ruth v. Climax Molybdenum Co. (CCA Colo.) 93 F. 2d. 699.

III.

Plaintiff is barred from bringing his action in fraud against the company arising out of the alleged misrepresentations of Mr. Albertson and Mr. Chapman, since these acts and things were done as part of, in fact the actual heart of, the rehabilitation proceeding. The specific acts and things done were approved by the Idaho District Court in its' order terminating

the rehabilitation. Plaintiff had notice of hearing on this matter, he had employed counsel to represent his interests, made no objection at the time of the entry of the order, has made no attempt to reopen the proceedings nor to ask the Idaho District Court to reconsider its' decision, has taken no appeal, and the order is final. It is difficult to imagine a more clear case of a collateral attack on the judgment of a State court. It is not only hornbook law that this cannot be done, but the only authorities bearing on the validity of orders in rehabilitation are unanimous in holding that the judgment cannot thus be collaterally attacked.

This very court in its' recent decision in the case of Liberty National Insurance Co. v. Reinsurance Agency, Inc., (C. C. A. Ida.)) 307 F. 2d. 164, concerning this selfsame rehabilitation proceeding, held that said judgment of the state court approving the actions of the state appointed rehabilitator, who had cancelled an agency contract between the parties, was binding upon the parties and that the Reinsurance Agnecy, Inc. had no right to question the validity of such cancellation in the federal court.

This court said therein:

> "The Idaho State Court's authority respecting the subject of this litigation including the question whether or not the commission contract of September 1, 1955 should be cancelled is prior and paramount to this Court's authority touching the same subject. Hutchins v. Pac. Mut. Life Ins. Co., 9 Cir., 97 F. 2d. 58, 60, and cases there cited."

> "To determine in the present action appellee's re-

quested relief based on its repudiation of the State Court's approval of cancellation of the September 1, 1955 contract is re-decide in a federal court not appellee to the State Court what was previously decided by the Idaho State Court

when it had unquestioned jurisdiction in the rehabilitation proceeding. In that proceeding on that question of cancellation, appellee was if it wished privileged to have a hearing, as expressly provided in the Idaho State Insurance Code."

"Under a well-known legal principal appellee is supposed to have known that law and to have contracted with it in mind."

"* * * * Appellee, however, did not seek a hearing in that State Court proceeding, took no court action therein, and the cancellation of the contract became final as to appellant and appellee with the approval of such cancellation by the State Court's judgment and order. Appellee, as well as appellant, if aggrieved, could and should have in that proceeding laid the foundation for proper appellate review."

IV.

The essential elements of an action for fraud and deceit are not present here. The essential elements required to sustain an action for fraud consist of an untrue representation or statement of past or existing material fact, which representation or statements made with speaker's knowledge of its' falsity or ignorance of its' truth and his intention that recipient will act thereon, recipient's ignorance of the untruth and his right to rely and reliance thereon to his damage.

Weitzel v. Jukich, 73 Ida. 301, 251 P. 2d. 542
23 Am. Jur. 773, Sec. 20.

The alleged representations that the defendant would furnish green cards, excess limits and expanded coverage to other countries could not amount to misrepresentations of fact, even if made. Such statements at best were promissory in nature and concerned matters that were not within the power or control of the persons allegedly making the promises. It is a general rule that fraud cannot be predicated upon statements which are promissory in nature when made and relate to future actions or conduct, upon the mere failure to perform a promise or upon failure to fulfill an agreement to do something at a future time or to make good subsequent conditions which have been assured, since non-performance alone has frequently been held to not even constitute evidence of fraud.

23 Am. Jur. Sec. 38, pp. 799-801.

It is true that a fraud may be predicated upon a promise made without the intention to perform, but this cannot be proved merely by proving a promise and a failure to perform.

The evidence clearly discloses that the plaintiff did not, in fact, rely on any representations made by Mr. Albertson or Mr. Chapman, whether true or false, that any representations they may have made as to defendant's financial condition were expressed and understood as nothing more than honest statements of opinion, based upon reasonable grounds and that the plaintfif wasn't induced by them to forbear inquiry as to their truth but rather was encouraged to investigate for himself and did.

It is a fundamental principal of the law of fraud, regardless of the form of relief sought, that in order to secure redress, the representee must have relied upon the statement or representation as an inducement to his action or injurious change of position. Moreover, the representation must be the proximate cause of such action or change of position, i. e., it must have been acted on in the manner contemplated by the party making it or else in some manner reasonably probable.

Nelson v. Hoff, 70 Ida. 354, 218 P. 2d. 345
23 Am. Jur., Sec. 141, p. 939, et seq.

In any fraud case, in order to secure relief, the complaining party must honestly confide in the representation or, as has been said, must reasonably believe them to be true. The law will not permit one to predicate damage upon statements which he does not believe to be true. A party has no right to rely upon alleged misrepresentations where he is aware of the falsity thereof or has reason to doubt the truth thereof.

23 Am. Jur., Sec. 146, p. 951.

A representation which is an honest expression of opinion, based upon reasonable grounds, and which is expressed and understood as nothing more than an opinion, cannot be made the basis of actionable fraud.

Barron v. Koenig, 80 Ida. 28, 324 P. 2d. 388.

V.

The evidence shows, that even though the plain-

tiff admits to receiving knowledge on or about February 1, 1957, that his money had been turned over to the defendant, which fact he claims to be a fraud upon him, he thereafter, without voicing any such claim, continued as President and a director of defendant, issued the stock certificates to himself and others, continued his agency at the expense of defendant, solicited the large investment of funds by the Becker Group, failed to intervene in the state court hearing ending the rehabilitation and voted his stock, among other things. Plaintiff has by such action and conduct waived any right he may have had to sue for damages or rescind.

The principle is well settled that a person defrauded in a transaction may, by conduct inconsistent with an intention to sue for damages for fraud, waive the right to sue. Likewise, one who, uninfluenced by the fraud, deals with the property as his own after having fully discovered that fraud has been practiced upon him in the contract or transaction by or through which he acquired the property, thereby waives his right to rescind.

24 Am. Jur. Sec. 209-210, pp. 34-37.

VI.

It is a general rule of law that if a party intends to rescind a contract, he must return the consideration received therefor and put the parties back in their former position as nearly as possible. During the period from January, 1957, when plaintiff made his investment, to the time the agency contract was terminated, defendant lost over twice the amount of money that plaintiff is now suing for on account of

plaintiff's agency business in Germany, which business the defendant would have discontinued except for plaintiff's purchase of defendant's stock. The defendant can only be returned to the status quo by the payment of a substantial amount of money to it.

> A party seeking to rescind a stock subscription for fraud of the corporation's agents, must rescind it as a whole and if he has received anything under it, he must return what he has received or offer to return it.
>
> Gordon v. Ralston, (Ore.) 62 P. 2d. 1328.

ARGUMENT ON CROSS-APPEAL

I.

The corporate entity in this case should be disregarded. There have been too many cases and too many articles and treaties written on this subject to cover them all. The subject in general is covered in 1 Fletcher Cyclopedia of Corporations, Sec. 41, p. 134 et seq. Fletcher states the general rule that "Notwithstanding the lack of agreement on these points, practically all authorities agree that under some circumstances in a particular case, the corporation may be disregarded as an intermediate between the ultimate person or persons or corporation and the adverse party; and should be disregarded in the interest of justice in such cases as fraud, contravention of law or contract, public wrong, or to work out the equities among members of the corporation internally and involving no rights of the public or third persons. There is a growing tendency of courts to do so." 1 Fletcher Cyclopedia Corporations 134. "Another rule is that, when the corporation is the mere

alter ego, or business conduit of a person, it may be disregarded." 1 Fletcher Cyclopedia Corporations,

Idaho recognizes this rule. *See Metz v. Hawkins,* 64 Idaho, 386, 133 P. 2d. 721. In this case the defendant looked to the plaintiff as an individual to carry on its business in Germany. He was its agent, although he operated technically through a corporate setup. He was the one who was originally bonded and not the corporation. The doctrine is particularly applicable where the subject matter in controversy involves the corporation as well as the individual. In this case the plaintiff put up the money primarily for the purpose of saving the business of the corporation. In fact, he put up the money from the funds belonging to the corporation and he was thus, in fact, acting for the corporation when he made the investment and not acting for himself personally. He took advantage of his control over the corporation to accumulate $50,000.00 or more in premiums due to provide himself with an offset on his personal claim against the company. He went through the formality of attaching these funds, but never carried through to the point of answering the writ of attachment, although it was long past due. He and he alone had been responsible for the corporation failing and refusing to make an accounting for the premiums that have been collected, until the time the pre-trial order was entered herein when the plaintiff acknowledged that the Transatlantic Company was indebted to defendant in the amount of $49,297.58 for unremitted premiums. These premiums were collected on behalf of the Liberty National Insurance Company and under the agency agreement were the absolute property of the defendant. He was responsible for converting

these funds to his own use. For him to hide behind the separate entity of the corporation under such circumstances would, in fact, permit and aid and abet the misappropriation of the funds of the Liberty National Insurance Company.

It appears that in this case there should be no question in anyone's mind that Mr. Lange was the responsible agent for the Liberty National Insurance Company to see that the money that was collected in Germany as funds of the Liberty National Insurance Company were not diverted to some other channel.

The facts and circumstances of this case make applicable the rule announced by the Idaho Supreme Court in the case of Metz v. Hawkins, supra, wherein it held:

> A corporate entity may be disregarded when it is shown that there is such a unity of interest and ownership that individuality of corporation and stockholders, officers or directors has ceased, and that observance of the fiction of separate existence would sanction a fraud or promote an injustice.

CONCLUSION

This defendant submits that the judgment of the trial court in determining that the plaintiff is not entitled on any legal or equitable ground whatever to rescind his stock subscription and that his action must be dismissed is amply supported by substantial and convincing evidence and that therefore the same must be sustained by this appellate court. Additionally, said decision is entitled to be sustained on the basis of any or all of the affirmative defenses pre-

sented, and, in particular on the res adjudicata principle adhered to by this court in connection with this very rehabilitation proceeding in its very recent decision in Liberty National Insurance Co. v. Reinsurance Agency, Inc. (C. C. A. Ida.) 307 F. 2d. 164.

The defendant further submits, however, that equity demands that the defendant recover from the plaintiff, as the alter ego of Transatlantic Casualty Underwriters, Inc., the admittedly withheld premium monies in the amount of $49,297.58, the same being by the agency agreement the absolute property of the defendant and tanamount to trust funds in the hands of plaintiff's said agency company. Any demands of Transatlantic Company thereagainst can be and should now be the subject of an independent action for that purpose, and should not preclude ultimate and complete justice between these parties on the issues presented herein.

IT IS, THEREFORE, RESPECTFULLY SUBMITTED, that the considered judgment of the lower court be sustained in favor of this defendant on the claim of the plaintiff and that it be reversed to favor the claim of this defendant against the plaintiff.

Respectfully submitted,

McNAUGHTON & SANDERSON.

By: .....

A Member of the Firm
Attorneys for the Appellee
& Cross-Appellant
Coeur d'Alene, Idaho.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance therewith.

One of the Attorneys for Appellee and Cross-Appellant.

Service of the above and foregoing Brief of Appellee is hereby admitted and threec opies have been rceived by me on this.....day of February, 1963.

Attorney for Appellant.

No. 18237

United States
Court of Appeals
for the Ninth Circuit.

JEAN RENOIR and DIDO FREIRE RENOIR,

Petitioners,

v

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

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TOPICAL INDEX

TABLE OF AUTHORITIES

[CASES CITED]

PAGE

[STATUTES CITED]

[I.R.S. RULES]

[TEXTS CITED]

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OPINION BELOW

The opinion of the Tax Court of the United States is reported in 37 T. C. 1180.

JURISDICTION

This petition has been filed to review a decision of the Tax Court of the United States involving the income tax liability of petitioners for the taxable years 1956 and 1957.

Notice of deficiency was mailed to petitioners on March 28, 1960 [R. 9, 16], and the petition for redetermination of the deficiency was filed with the Tax Court on June 6, 1960. [R.3] The petition was filed pursuant to § 6213(a) of the Internal Revenue Code of 1954. The decision of The Tax Court was entered on May 31, 1962. [R.4]. Petition for Review was filed and notice thereof served upon counsel for respondent on August 20, 1962. [R.4]

The income tax returns of petitioners for the years 1956 and 1957 were filed with the District Director of Internal Revenue at Los Angeles, California [R. 7.14,16]. The Petition for Review was filed pursuant to § 7483 and jurisdiction is invoked under § 7482 of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and regulations herein involved are set forth in the Appendix, infra.

STATEMENT

The taxes in controversy herein are Federal income taxes for the taxable years ended December 31, 1956 and December 31, 1957. [R. 5,16].

This case was submitted to the Tax Court on a written Stipulation of Facts, [R. 16-18]

Petitioners arrived in France on October 1, 1953 and remained continuously in Europe until July 15, 1956 when they departed France to return to the United States. They were, thus, present in foreign countries for a period in excess of 510 full days, in a period of eighteen (18) consecutive months.

During said period, Jean Renoir (hereinafter referred to as petitioner) performed personal services as a motion picture director and writer in France.

In 1956, petitioner received a salary in the amount of $35,000 in partial payment for personal services performed during said period.

In 1957, petitioner received a salary in the amount of $10,000 in partial payment for personal services rendered during said period.

Petitioners, Jean Renoir and Dido Freire Renoir, are husband and wife and were residents and domiciled in the State of California during all of the years herein referred to.

Petitioners filed their joint Federal Income Tax Returns (Form 1040) for the years 1956 and 1957 with the District Director of Internal Revenue at Los Angeles, California. Said returns were prepared and filed on the cash receipts and disbursements basis.

In said returns so filed petitioners excluded said $35,000 received in 1956 and said $10,000 received in 1957 as being non-taxable under § 911(a)(2) of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Do the words "taxable year" appearing in § 911(a)(2) of the Internal Revenue Code of 1954 mean the year in which the services were performed or the year in which the income attributable to the services performed was received?

2. Is each petitioner entitled to the exclusion provided for in § 911(a)(2), by reason of their being husband and wife domiciled in and residents of the State of California, a community property state?

SPECIFICATIONS OF ERRORS

The Tax Court erred:

I.

1. In concluding that the words "taxable year" mean the year in which the income was received;

2. In failing to conclude that the words "taxable year" mean the year in which the services were performed;

3. In failing to conclude that under Regulation 118, § 39.116-1(a) and (b), issued by the Commissioner of Internal Revenue, with the consent of the Treasury Department, which were in effect in 1956 and 1957, until at least, August, 1957, time of receipt of amounts which otherwise qualified under the applicable code sections set out in the Appendix, infra, was immaterial.

II.

In failing to conclude that each petitioner is entitled to such $20,000 exclusion or ratable portion thereof, by reason of their being husband and wife domiciled in and residents of the State of California, a community property state:

(a) Said income earned by reason of the rendition of personal services by Jean Renoir during the period October 1, 1953 to July 15, 1956, was the community income of petitioners earned and owned one-half by each.

+

ARGUMENT

I.

THE WORDS "TAXABLE YEAR" MEAN THE YEAR IN WHICH THE SERVICES WERE PERFORMED AND NOT THE YEAR IN WHICH THE INCOME WAS RECEIVED AND THEREFORE TIME OF RECEIPT IS IMMATERIAL.

This Court in Ladd v Riddell, 309 F. 2d 51, recently held against taxpayers on this point. Petitioners urge this Court to reconsider its views and to reconsider an argument made in the Ladd case but not mentioned in its decision.

In deciding the Ladd case, this Court based its decision solely on the definition of "taxable year" contained in subparagraph (23) of § 7701(a) of the Internal Revenue Code of 1954 and on the Tax Court's decision in the instant case, which decision was likewise bottomed solely on said subparagraph (23).

Neither this Court nor The Tax Court mentions paragraph (a) of said § 7701 which reads:

> Section 7701. Definitions.
>
> (a) When used in this title, when not otherwise distinctly expressed or manifestly incompatible with the intent thereof - (underscoring added).

Clearly the underscored words appearing in (a) above state that the words "taxable year" can have a different meaning than that contained in said subparagraph (23). Such a different meaning is required when distinctly expressed or when said words are so used in a manner

manifestly incompatible with the intent of subparagraph (23).

It is submitted that it is equally clear that the use of the words "taxable year" in § 204 of the Technical Changes Act of 1953, and in § 911 (a)(2) of the Internal Revenue Code of 1954, distinctly expresses a different meaning from that given in subparagraph (23) and that said words as so used are manifestly incompatible with the definition thereof in said subparagraph.

The words "taxable year" appear in said §§ 204 and 911 (a)(2) in the following context:

> "If the 18 month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18 month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year . . ." shall not exceed the stated ratio. (Underscoring added)

The only "18 month period" referred to in said section is " . . . any period of 18 consecutive months" during which an individual citizen of the United States" is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States . . . . if such amounts constitute earned income . . . . . attributable to such period." (Underscoring added). Manifestly "the 18 month period" used in said limitations provisions must refer back to

"any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, . . .". Therefore, it must follow that the "taxable year" which is included in "the 18 month period" is the taxable year in any period of 18 consecutive months during which an individual citizen of the United States is present in a foreign country or countries during at least 510 full days in such period. Hence, "taxable year" as used in said section means the year during which the services were performed and the income earned.

Congress emphasized its intent that "taxable year" means the year during which the services were performed and the income earned by distinctly expressing what was to be excluded from gross income and exempt from taxation in the following words "amounts received from sources without the United States . . . . if such amounts constitute earned income . . . attributable to such period . . ." (Underscoring added). Thus, Congress plainly and unequivocally stated its intention that amounts attributable to such period are not to be included in gross income and shall be exempt from taxation. The words "attributable to" mean ascribed to or belonging to or pertaining to or due to. [Webster's New International Dictionary, Second Edition; Elmer Reise, 35 T.C. 571]. Thus, the amounts to be excluded from gross income are the amounts which are ascribed to or

belong to or pertain to or due to such period. What period? Such period can only refer back to "any period of 18 consecutive months" during which taxpayer "is present in a foreign country or countries during at least 510 full days in such period. . ." (Underscoring added). It thus appears irrefutable that what is not to be included in income are amounts attributable to the period of 18 consecutive months. And Regulations 111 and 118 so provided in the following language:

> "If attributable to a period of 18 consecutive months in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received." (Underscoring added) [Reg. 118, § 116-1(b)(1).]

These regulations were in full force and effect when the Internal Revenue Code of 1954 was enacted, thus giving them the full force of law.

The correctness of petitioners' contention is demonstrated by Congressional action in rewriting § 911 in the Revenue Act of 1962. This is the first change made in § 911 since its enactment in the Internal Revenue Code of 1954 and is also the first change made with respect to the subject matter of said section since § 204 of the Technical Changes Act of 1953 amended § 116 (a)(2) of the Internal Revenue Code of 1939.

In rewriting § 911, Congress showed its displeasure with Revenue Ruling 54-72 and Regulations 1.911-1(b)(2)(ii)(c), both of which, in effect, provide that "taxable year" means year of receipt and refused to follow them or to approve them.

Subsection (c)(2) of § 911 of the Revenue Act of 1962 provides "that amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed". [Appendix, infra]. It is submitted, that Congress has shown that its intent has always been that "taxable year" meant the year in which the services were performed and not the year of receipt.

In Evelyn Handcock-Ferguson, 21 T.C.M. Dec. 25, 695 (M), par. 62, 237 P-H Memo TC, the Tax Court again held that "taxable year" means year of receipt. This case is on review to the United States Court of Appeals for the Second Circuit. Par. 56, 337 Prentice Hall Federal Taxes.

II

REGULATIONS 118, § 39.116-1 (a) AND (b) WERE GIVEN THE FORCE OF LAW BY THE ENACTMENT OF § 116 (a)(1) AND (2) OF THE INTERNAL REVENUE CODE OF 1939 AS § 911 (a)(1) AND (2) OF THE INTERNAL REVENUE CODE OF 1954, WITHOUT CHANGE.

The contention herein made under this caption was fully submitted to this Court in the Ladd case, supra.

This Court in its opinion did not mention this contention.

Petitioners herein will not elaborate on this argument as fully as was done in the Ladd case, supra. However, petitioners feel that it should again be brought to this Court's attention, particularly in view of Congress' rewriting § 911 in the Revenue Act of 1962.

The exclusion from gross income for income tax purposes of income earned in a foreign country by a citizen of the United States was contained in the original Internal Revenue Code of 1939 as § 116(a). In general, it provided for such exclusion if the citizen was a bona fide resident of a foreign country or countries.

§ 321 of the Revenue Act of 1951 amended § 116 to provide for an additional such exclusion. (Appendix, infra). This is the so-called "presence abroad" or "eighteen month" exclusion. Said § 321 rewrote said § 116 by making the bona fide resident exclusion § 116(a)(1) and added the presence abroad exclusion as § 116 (a)(2) (Appendix, infra).

Said new paragraph (2) inserted by said § 321 of the Revenue Act of 1951 provided that if a citizen of the United States, during any eighteen consecutive month period, is present in a foreign country or countries during at least 510 full days in such period amounts received from sources without the United States, if such amounts constitute earned income, attributable to such period, are to be

excluded from gross income in computing his income tax due the United States.

§ 321 of the Revenue Act of 1951 was added by the Senate Committee. It was not in the bill passed by the House of Representatives. The Senate Committee Report states that § 116(a) as it then provided had two defects. The first was that an individual was denied the exclusion of his first year as a bona fide resident, and the second was that the term "bona fide" resident abroad had been construed quite strictly with the result that many persons who had worked abroad for relatively long periods of time had been unable to meet the "bona fide resident" test. The reasons stated by said Committe for the failure to meet the "bona fide resident" test was (1) the nature of the individual's work, and (2) the individual's presence abroad was for a stated time, such as manager, technicians and skilled workmen who are induced to go abroad for periods of 18 to 36 months. The said Committee stated that it believed that it was particularly desirable to encourage men with technical knowledge to go abroad. The Committee then said:

> "As a result your Committee has added a paragraph to Section 116(a) of the Code providing that income earned abroad by a citizen of the United States who is present in a foreign country or countries for 17 out

> of 18 consecutive months is to be excluded from income . . . ." (Senate Committee Report, United States Code, Congressional and Administration Service, 1951, 82nd Congress--1st Session, Revenue Act of 1951, West Publishing Co.--Edward Thompson Co., p. 3144)."

It is to be noted that for the first time Congress inserted the words "attributable to such period" in § 116(a)(1) "Bona Fide Resident" and used the same words in new 116(a)(2) "Eighteen Months Presence in a Foreign Country". It is believed and submitted that the reason for the use of said words was to overcome the effect of some earlier decisions which held that income received after the termination of the bona fide residence period was not excludable. This reasoning is supported by the Regulations adopted in 1953, (as will be more fully discussed below) wherein it is provided both with respect to the bona fide residence and the 18 months presence that if the taxpayer meets the requirements of either Section, the amounts are excluded irrespective of when received.

Congress next amended § 116(a) by Public Law 287, which became effective August 15, 1953. It is to be noted that the Commissioner of Internal Revenue had not yet amended his regulations to reflect the changes made in § 116(a) by the

Revenue Act of 1951. § 204(a) of Public Law 287 (commonly referred to as Technical Changes Act of 1953) amended § 116(a)(2) by placing a ceiling of $20,000.00 for each taxable year, and a pro rate thereof for a part of a taxable year, on the amount of the excluded income. This is the only change made in said section.

After the enactment of § 204(a) of the Technical Changes Act of 1953, the Commissioner completely rewrote § 29.116-1 of Regulations 111 to reflect the changes made in § 116(a) by both the Revenue Act of 1951 and the Technical Changes Act of 1953. On August 27, 1953, he promulgated T.D. 6039 amending § 29.116-1 of Regulations 111. In both §§ 116-1(a) relating to bona fide residence and 116-1(b) relating to physical presence for 17 of 18 consecutive months, he provided that for amounts which qualified for the respective exclusions, "the amounts shall be excluded from gross income irrespective of when they are received." [Underscoring added]. § 29.116-1(b) later states, "The exclusion granted by Section 116(a)(2) applies to income attributable to any period of 18 consecutive months during which the citizen satisfies the 510 full day requirement. . . ." [Underscoring added]

On September 23, 1953, the Commissioner of Internal Revenue promulgated Regulations 118 which superseded Regulation 111. §§ 39.116-1(a) and (b) of Regulations 118 were

substantially the same as §§ 29.116-1(a) and (b) of Regulations 111 as amended by T.D. 6039, August 27, 1953. Both sections of Regulations 118 contained the provision quoted above relating to the amounts being excluded irrespective of when they are received, and 116-1(b) contained the other above quoted provisions. §§ 39.116-1(a) and 39.116-1(b) remained unchanged until August 14, 1957, when Regulations § 1.911-1 were promulgated by T.D. 6249 under the Internal Revenue Code of 1954. (1961 Prentice-Hall Vol. 1, ¶ 8823.)

The Internal Revenue Code of 1954 re-enacted § 116(a)(1) and (2) of the Internal Revenue Code of 1939 as § 911(a)(1) and (2), without a single change. (Appendix, infra). At the time of the enactment of the said 1954 Code, Regulations 118, §§ 116-1(a) and (b) were in effect.

Thus, Regulations 118, §§ 116-1(a) and (b) were given the force of law.

> Old Mission Portland Cement Co. v Helvering, 293 U.S. 289, 555 S.Ct. 158, 35-1 U.S.T.C. ¶ 9009;
>
> Massachusetts Mutual Life Insurance Company v United States, 288 U.S. 269, 53 S.Ct. 337, 3 U.S.T.C., ¶ 1045;
>
> B.D. McCaughn, Collector v Hershey Chocolate Co., etc., 283 U.S. 482, 51 S.Ct. 510, 2 U.S.T.C., ¶ 738.

In the latter case, the Supreme Court said:

> "The reenactment of the statute by Congress, as well as, the failure to amend it in the face of the consistent administration construction, is at least persuasive of a legislative recognition and approval of the statute as construed."

In Massachussets Mutual Life Insurance Company v United States, supra, the Supreme Court said:

> "The Congress in the Revenue Acts of 1928 and 1932 reenacted Section 245 without alteration. This action was taken with knowledge of the construction placed upon the Section by the official charged with its administration. If the legislative body had considered the Treasury interpretation erroneously it would have amended the Section. Its failure so to do requires the conclusion that the regulation was not inconsistent with the intent of the statute."

And in Old Mission Portland Cement Company v Helvering, supra, the Supreme Court said:

> "These provisions were retained, without material change, in the regulations promulgated under the 1924, 1926 and 1928 acts . . . as Section 234 (a) (1) to which they pertain has been reenacted in several revenue acts, the regulation now has the force of law." . . . . (citing the McCaughn v Hershey Chocolate Co., and the Massachusetts

Mutual Life Insurance Co. v United States cases, supra .)

Said §§ 116-1 (a) and (b) of Regulations 118 remained in effect until August, 1957, when they were superceded by Regulations §§ 1.911-1(a) and (b). The language "the amounts shall be excluded from gross income irrespective of when they were received" was retained in § 1.911-1 (a) but was deleted from § 1.911-1(b). Although no contrary language was included in § 1.911-1(b) an example was included to indicate that "taxable year" meant year of receipt. (Regulations § 1.911-1 (b)(2)(ii)(c), Appendix, infra). This Regulation was in effect when the Revenue Act of 1962 was enacted. Congress repudiated it and hence it never acquired the force of law. While Congress did not go back to the broad language of §§ 116-1(a) and (b) "irrespective of when received" it did provide for exclusion of amounts received in the taxable year following the year in which the services were performed. § 911 (c)(4) as rewritten by the Revenue Act of 1962 provides:

> "(4) Requirement as to time of receipt.-- No amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded under subsection (a). (Appendix, infra).

Said subsection (4) applies equally to the bona fide residence exclusion and to the presence abroad exclusion.

It is submitted, therefore, that Congress clearly repudiated year of receipt as the "taxable year" and re-established year of performance and in addition repudiated in part that time of receipt after the close of the year is material.

III

EACH PETITIONER IS ENTITLED TO SUCH EXCLUSION BY REASON OF BEING HUSBAND AND WIFE DOMICILED IN AND A RESIDENT OF THE STATE OF CALIFORNIA, A COMMUNITY PROPERTY STATE.

Petitioners are husband and wife and residents of and domiciled in the State of California. [R. p. 16] California is a community property state. One-half of the earnings of either spouse vest in and belong one-half to each spouse at the very moment of earning and/or receipt. §§ 164, 163, 162 and 161 (a), Civil Code of California; United States v Malcolm, 282 U.S. 729, 51 S.Ct. 184, 2 U.S.T.C. 650, citing Poe v Seaborn, 282 U.S. 101, 51 S.Ct. 58, 2 U.S.T.C. 611; Goodell v KOCH, 282 U.S. 118, 51 S.Ct. 62; 2 U.S.T.C. 612; Hopkins v Bacon, 282 U.S. 122, 51 S.Ct. 62, 2 U.S.T.C. 613.

The earnings of the husband were never his property, but were the property of the community. Poe v Seaborn,

supra. That being so, the earnings here involved constituted "earned income" of the community. Graham v Commissioner (9th Cir.), 95 Fed. 174, 38-1 U.S.T.C. 9172. The question in the Graham case was whether the wife's community one-half of the income was "earned income". The court, in holding that the wife's community one-half of the earnings did constitute "earned income", said:

> "All of said community income--petitioner's half as well as her husband's half--was 'received as compensation for personal services actually rendered' and was, therefore, within the statutory definition of 'earned income'."

Respondent therein then contended that the phrase "personal services actually rendered" meant rendered by taxpayer. The Court stated:

> "The Board found that said community income was received as compensation for professional services rendered by petitioner's husband. Respondent assumes, erroneously, that these services were rendered by petitioner's husband individually, on his own account and for himself alone, thus assuming as a fact that which, in Washington, is a legal impossibility. When a married man residing in Washington practices a profession or engages in any gainful occupation or activity, he does so

as the agent of a marital community consisting of himself and his wife. Poe v Seaborn, supra. He cannot do so in any other way or in any other capacity. Services rendered by him are actually rendered by the community, that is to say, by him and his wife, equally. So, in this case, petitioner was, no less than her husband, the actual renderer of the services for which they received as compensation the community income above referred to.

"That petitioner did not personally participate in the professional labors of her husband is immaterial. One may actually render a personal service without personally performing the acts constituting the service. Otherwise, a partnership acting through one of its members, or a principal acting through an agent, could not actually render a personal service, the truth being, of course, that such services can be and, in countless instances, are actually so rendered." [Underscoring added].

In Pierce v U.S. (9th Cir.) 254 F. 2d 885, I A.F.T.R. 2d 1498, the Court held that the wife's half of the community income, as well as the husband's half, constituted "business income". The Court said:

"But the warp and woof of community property law in the old community property

> states is that when the husband or the wife is at work, the community is at work; at least, in working, the worker is carrying on the business of the community."

I.T. 3665, 1944 Cumulative Bulletin 161, held that a wife was entitled to exclude her half of the community income derived from sources within a possession of United States where only husband meets the requirements of § 251 of the 1939 Code.

Kaufman v Commissioner, 9 B.T.A. 1180, held that where the income of the husband is exempt from taxation, such income retains its exempt status in the hands of the wife, where the wife is entitled to one-half of the income because of its being the community property.

Rev. Rul. 54-16, I.R.B. 1954-2, 18; 545 C.C.H. 6139 Modified I.T. 3665, supra, by reason of the decisions in Francis v Mullen, 14 T.C. 1179 and Markham v U.S. District Court, Southern District of California, Central Division, June 23, 1953, 53-2 U.S.T.C. 9462. In said ruling, it is said:

> "Under Section 116(a) of the Code income earned by either spouse while a bona fide resident of a foreign country for an uninterrupted period of an entire year or his or her presence in a foreign country for 17 months is exempt as to

> both spouses irrespective of how much or what kind of other income either or both may have." [Underscoring added]

Rev. Rul. 55-246 I.R.B. 1955-18, 7 held that a community property state husband and wife, are each entitled to the exemption under said § 911(a) on their separate returns so long as one of the spouses meets the requirements of either 911(a)(1) or 911 (a)(2), regardless of whether the other spouse meets the specified requirements in § 911(a) of the Code. The ruling states:

> "The division of income on the community property basis does not alter the exempt character of income entitled to exemption under Section 911(a) of the Code. See Rev. Rul. 54-16, C.B. 1954-1, 157."

In Fred MacMurray, 21 T.C. 15, each spouse was entitled to a loss not to exceed $50,000.00 for each of five years under § 130, Internal Revenue Code 1939. Rev. Rul. 54-179, Internal Revenue Bulletin 1954-21, 6, 545 CCH, § 6294, confirmed the holding in the MacMurray case. See also Rev. Rul. 54-178, I.R.B. 1954-21, 5, 545 CCH § 6293, where the spouses are partners to the same effect.

See also Technical Amendments Bill of 1958 (H.R. 8381) where in § 2 of the House bill, it was proposed to limit the

retirement income credit to the spouse in a community property state who individually performed the services and in the Senate bill it was proposed to put noncommunity property States on the same basis as community property states by treating earned income of a spouse as having been earned half by each spouse. This proposed amendment was killed in conference. Thus, both Houses recognized that spouses in community property states each received the retirement income credit by reason of the income being community property.

From the foregoing, it is inescapable and unanswerable that each petitioner is entitled to the exclusion under the provisions of § 911(a)(2) Internal Revenue Code 1954.

The identical arguments, authorities and citations contained herein were presented in the brief filed with the Tax Court. But the Tax Court ignored all of the citations and authorities set forth in said brief, except Rev. Rul. 55-246, 1955-1 C.B. 92. The Tax Court held said ruling inapplicable because (1) separate returns were involved in the ruling, while a joint return was filed by the Renoirs, and (2) because the limitation applies to income, not to the individual taxpayer. The Tax Court does not indicate or mention why the law should differ when a joint return is filed and when separate returns are filed. There is no difference. It is well known that joint returns were permitted so as to give non-community property taxpayers the same "break" that

community property taxpayers were enjoying. The introduction of joint returns was not intended, and indeed did not, make one set of tax rules applicable to them and another set of tax rules applicable to separate returns. There is nothing in either the law or the regulations to justify such distinction. While it is true, as the Tax Court said, the limitation applies to the income, not to individual taxpayers, the court completely overlooks the fact that the community income belongs one-half to each. This being true, the exclusion applies to the income of each spouse. Equally important is that the Tax Court ignored the reference in Rev. Rul. 55-246 to Rev. Rul. 54-16.

Finally, on this point, the Tax Court states petitioner's interpretation would favor taxpayers in community property states and that without a clear-cut statutory mandate, the Court would not attribute to the Congress an intention to authorize a double exclusion of such income for taxpayers in community property states as compared with other taxpayers. Congress in the Revenue Act of 1962 has now given a clear-cut statutory mandate for years ended prior to the effective date of the amendment of § 911. § 911(c)(3) of said Act reads:

> "(3) Treatment of community income. - - In applying paragraph (1) with respect to amounts received for services performed by a husband

> or wife which are community income under community property laws applicable to such income, the aggregate amount excludable under subsection (a) from the gross income of such husband and wife shall equal the amount which would be excludable if such amounts did not constitute such community income." (Appendix, infra).

The amendments made to § 911 by the Revenue Act of 1962 apply to years ending after September 4, 1962, with certain exceptions not here applicable. (§ 11 (c)(1) of Public Law 87-834, Oct. 16, 1962, Appendix infra.)

C O N C L U S I O N

In conclusion, it is submitted that the Tax Court of the United States erred in holding that "taxable year" as used in § 911(a)(2) of the Internal Revenue Code of 1954 means year of receipt; in failing to hold that "taxable year" means the year in which the services were performed; in determining that the income received by petitioners in 1956 and 1957 attributable to services performed during a period when petitioners qualified under said § 911 (a)(2) as being physically present in foreign countries for a period of more than 510 full days in an 18 consecutive

month period is taxable to them in 1956 and 1957; and in failing to determine that each petitioner is entitled to the exclusion provided in said § 911(a)(2) by reason of said income being the community income of petitioners under the law of the State of California.

Respectfully submitted,

J. EVERETT BLUM

Attorney for Petitioners.

CERTIFICATE RE RULES 18 AND 19

I, J. EVERETT BLUM, the attorney for petitioners, certify that I have examined Rules 18 and 19, as amended, and in my opinion, the foregoing Brief conforms to all requirements of said Rules, as amended.

/S/ J. EVERETT BLUM

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APPENDIX

STATUTES AND REGULATIONS INVOLVED.

The following statutes are involved herein:

Internal Revenue Code of 1939:

Section 116(a) as amended by the Revenue Act of 1951:

"Sec. 116. Exclusions from Gross Income:

In addition to the items specified in Section 22(b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(a) Earned Income from Sources without the United States.—

(1) Bona fide resident of foreign country.—

In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; but such individual shall not be allowed as a deduction from his gross

income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) Presence in foreign country for 17 months. —— In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(3) Definition of earned income.—For the purposes of this subsection 'earned income' means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of

a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, under regulations prescribed by the Commissioner with the approval of the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 20 per centum of his share of the net profits of such trade or business, shall be considered as earned income."

Section 116 as amended by the Revenue Act of 1951 and Section 204(a) Public Law 287 (Technical Changes Act of 1953).

"I. R. C., Sec. 116. Exclusions from Gross Income.

In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(a) Earned Income from Sources without the United States.—

(1) Bona fide resident of foreign country.—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an

entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3))attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) Presence in foreign country for 17 months.—In the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (Except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

If the 18 months period includes the entire taxable year, the amount excluded under this paragraph for such taxable year

shall not exceed $20,000. If the 18 month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18 month period bears to the total number of days in such year.

(3) Definition of earned income.—For the purposes of this subsection, 'earned income' means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, under regulations prescribed by the Commissioner with the approval of the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess

of 20 per centum of his share of the net earned profits of such trade or business, shall be considered as earned income."

[Underscored words added by Public Law 287.]

Internal Revenue Code of 1954:

"Sec. 911. Earned Income from Sources Without the United States.

(a) General Rule.--The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) Bona fide resident of foreign country.--In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly

allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) Presence in foreign country for 17 months.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) if such amounts constitute earned income (as defined in subsection (b) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month

period bears to the total number of days in such year.

(b) Definition of Earned Income.—For purposes of this section, the term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income."

SEC. 7701 DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof --

* * * * *

(23) Taxable year. -- The Term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. * * *

SEC. 911 as amended by the Revenue Act of 1962 insofar as applicable herein:

Sec. 911. Earned Income From Sources Without the United States.

(a) General Rule. -- The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) Bona fide resident of foreign country. --In the case of an individual citizen of the United States who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterruppted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such uninterrupted

period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

(2) Presence in foreign country for 17 months.--In the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) which constitute earned income attributable to services performed during such 18-month period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

An individual shall not be allowed, as a deduction from his gross income, any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this subsection.

* *

(c) Special Rules.-- For purposes of computing the amount excludable under subsection (a), the following rules shall apply:

(1) Limitations on amount of exclusion.-- The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of --

(A) except as provided in subparagraph (B), $20,000 in the case of an individual who qualifies under subsection (a), or

(B) $35,000 in the case of an individual who qualifies under subsection (a)(1), but only with respect to that portion of such taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

(2) Attribution to year in which services are performed.--For purposes of applying paragraph (1), amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed.

+

(3) Treatment of community income.--In applying paragraph (1) with respect to amounts received from services performed by a husband or wife which are community income under community property laws applicable to such income, the aggregate amount excludable under subsection (a) from the gross income of such husband and wife shall equal the amount which would be excludable if such amounts did not constitute such community income.

(4) Requirement as to time of receipt.--No amount received after the close of the taxable year following the taxable year, in which the services to which the amounts are attributable are performed may be excluded under subsection (a)."

[Underscored words added by Revenue Act of 1962]

Sec. 11 (c), Revenue Act of 1962:

Effective date--Applies to taxable years ending after September 4, 1962, but only to amounts (a) received after March 12, 1962, and attributable to services performed after December 31, 1962, or (b), received after December 31, 1962, and attributable to services performed on or before December 31, 1962

unless on March 12, 1962, there existed a right (whether forfeitable or nonforfeitable) to receive such amounts.

Regulations 118, Section 39.116-1(a) and (b) (insofar as applicable):

"Reg. 118, Sec. 39.116-1. Earned Income From Sources without the United States —(a) Resident of a foreign country. (1) Amounts constituting earned income as defined in section 116(a)(3) shall be excluded from gross income in the case of an individual citizen of the United States who establishes to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, if such amounts are (i) from sources without the United States, (ii) attributable to such uninterrupted period, and (iii) not paid by the United States or any agency or instrumentality thereof. The exemption from tax thus provided is applicable to such amounts as are attributable to that portion of an uninterrupted period of bona fide foreign residence which falls within a taxable year during the course of which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one entire taxable year. If attributable to an uninterrupted period in respect of which the

citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received. The period during which the citizen was a bona fide resident of a foreign country or countries prior to the commencement of his first taxable year beginning after December 31, 1951, may be taken into account in determining whether such citizen has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year."

"(b) Presence in a foreign country. (1) Amounts constituting earned income as defined in section 116(a)(3) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i) from sources without the United States, (ii) attributable to such period, and (iii) not paid by the United States or any agency or instrumentality thereof. If attributable to a period of 18 consecutive months in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.

(2) For taxable years ending before January 1, 1953, there is no limitation upon the amount which may be excluded from gross

income pursuant to subparagraph (1). For taxable years ending after December 31, 1952, but only with respect to amounts received after such date, the amount excluded from gross income under the provisions of section 116(a)(2) shall not exceed $20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year. In the case of a fiscal year beginning in 1952 and ending in 1953 the exclusion of amounts received after December 31, 1952, shall not exceed the lesser of the amount determined under the two preceding sentences or an amount which is the same proportion of $20,000 as the number of days in such taxable year after such date is of 365 days. There is no limitation as to the total amount of the exclusion for amounts received prior to January 1, 1953, in the case of such a fiscal year."

Regulations, Section 1.911-1(a) and (b) under the Internal Revenue Code of 1954 (insofar as applicable):

"(a) Bona fide resident of a foreign country — (1) Qualifications for exemption. Amounts constituting earned income as defined in section 911(b) shall be excluded from the

gross income of an individual citizen of the United States who establishes to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, if such amounts are (i) from sources without the United States, (ii) attributable to such uninterrupted period, and (iii) not paid by the United States or any agency or instrumentality thereof. The exemption from tax thus provided is applicable to such amounts as are attributable to that portion of an uninterrupted period of bona fide foreign residence which falls within a taxable year during which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one entire taxable year. If attributable to an uninterrupted period in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.

(b) Presence in a foreign country — (1) Qualifications for exemption. Subject to the limitations in subparagraph (2), amounts constituting earned income as defined in section 911(b) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i)

from sources without the United States, (ii) attributable to such period and (iii) not paid by the United States or any agency or instrumentality thereof. For purposes of determining the right to the exclusion under section 911(a)(2) for a taxable year to which the Internal Revenue Code of 1954 is applicable, the period of presence in a foreign country may include a period prior to the beginning of such taxable year, even though the tax for such prior period is computed under the Internal Revenue Code of 1939. For example, the qualifying period may, in the case of a taxpayer who makes his return on the calendar year basis, cover the period from July 1, 1953, to December 31, 1954, for purposes of the exclusion allowed under section 911 (a)(2) for the taxable year 1954.

(2) Amount of exemption. (i) The amount excluded from gross income under the provisions of section 911 (a)(2) shall not exceed $20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year."

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the

following example:

Example. — A, a citizen of the United States who files his returns for the calendar year using a cash receipts and disbursements method, was privately employed and physically present in France from January 1, 1953, through July 15, 1955. On December 31, 1953, he received compensation in the amount of $20,000 for the services rendered by him during 1953. He left France on July 16, 1955, and returned to the United States. On August 1, 1955, he received $30,000, part of which was for the services rendered by him during 1954 and the balance of which was for his services rendered during the period January 1, 1955, through July 15, 1955. On January 15, 1956, A received an additional $10,000 for the services rendered by him during 1954.

(a) Since the $20,000 compensation received by A on December 31, 1953, was attributable to an 18-month period during at least 510 full days of which he was present in a foreign country, and since that 18-month period included his entire taxable year 1953, the entire $20,000 is exempt from taxation.

(b) Only $12,712.33 (232/365 X $20,000) of the $30,000 received by A on August 1, 1955, is exempt from taxation since only 232 days of his taxable year 1955 is included within such an 18-month period. The number of days (232) is determined by treating the first day of the 18-month period as coinciding with the

first day of the 510-day period ending July 15, 1955 (the last full day A was present in France), was February 21, 1954. Commencing with February 21, 1954, the 18-month period ends August 20, 1955. The number of days in that part of 1955 falling within the 18-month period is, therefore, 232 (January 1, 1955, through August 20, 1955). The amount excludable by A in 1955 ($12,732.33) is computed on the basis of the following formula:

$$\frac{\text{Number of days in that part of the taxable year falling within the 18-month period}}{\text{Number of days in the taxable year}} \times \$20,000$$

(Maximum amount excludable for an entire taxable year under section 911 (a)(2), or 232/365 x $20,000.

(c) None of the $10,000 attributable to the services rendered by A during 1954 but received by him in 1956 is exempt from taxation because no part of his taxable year 1956 is included within 18-month period. For the definition of "taxable year" see section 7701(a)(23).

* * * * * * * *

Rev. Rul. 54-72, 1954-1 Cum. Bull. 117:

Where a taxpayer meets the requirements of section 116 (a)(2) of the Internal Revenue Code regarding

presence in a foreign country or countries during at least 510 full days during any period of 18 consecutive months, but receives compensation attributable to such period in a taxable year ending subsequent to December 31, 1952, no portion of which falls within the 18-month period, no portion of such compensation received in such taxable year is excludable from his gross income.

Advice is requested as to the application of section 116 (a)(2) of the Internal Revenue Code (as amended by sec. 204 of the Technical Changes Act of 1953. Public Law 287, 83d Cong. C.B. 1953-2, 485) and Regulations 118 as amended by Treasury Decision 6039, C.B. 1953-2, 162, with respect to amounts received after December 31, 1952, attributable to earned income from sources outside the United States under the following circumstances:

Taxpayer worked abroad and met the requirements of section 116(a)(2) of the Internal Revenue Code regarding presence in a foreign country or countries during at least 510 full days during a period of 18 consecutive months. He returned to the United States at the end of 1952. In his taxable year 1953, no part of which fell within the 18 month period, he received compensation attributable to such period in the amount of $10,000.

Section 39.116-1(b) of Regulations 118, as amended by T. D. 6039, supra, which is applicable to amounts constituting earned income as defined by section 116(a)(3) of the Code, from sources outside the United States, provides in part as follows:

> (1) Amounts constituting earned income as defined in Section 116(a)(3) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i) from sources without the United States, (ii) attributable to such period, and (iii) not paid by the United States or any agency or instrumentality thereof. If attributable to a period of 18 consecutive months in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.
>
> (2) For taxable years ending before January 1, 1953, there is no limitation upon the amount which may be excluded from gross income pursuant to subparagraph (1). For taxable

> years ending after December 31, 1952, but only with respect to amounts received after such date, the amount excluded from gross income under the provisions of section 116 (a)(2) shall not exceed $20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year * * *

Subparagraph (1) quoted above is subject to the facts in the instant case, subparagraph (1) of the regulations quoted above, standing alone, indicates that the $10,000 would be excluded from gross income since it is earned income from sources outside the United States and is attributable to a period of 18 consecutive months during which the taxpayer was present in a foreign country for at least 510 full days. However, since no part of the taxable year in which the $10,000 was received falls within the 18-month qualifying period, the application of the limitation set forth in subparagraph (2) results in a figure of zero and no portion of the

$10,000 received in 1953, even though attributable to the qualifying period, is excludable from gross income.

The formula for such computation may be stated as follows, but refers only to taxable years ending after December 31, 1952, and only with respect to amounts received after such date:

$$\frac{\text{Number of days in that part of the taxable year of receipt falling within the 18-month period}}{\text{Number of days in the taxable year of receipt}} \times \$20,000 = \text{Maximum amount excludable.}$$

Application of the above formula to the facts in this case is illustrated as follows:

$$\frac{0}{365} \times \$20,000 = \text{Zero} = \text{Maximum amount excludable}$$

In view of the foregoing, it is held that where a taxpayer meets the requirements of section 116 (a)(2) of the Internal Revenue Code regarding presence in a foreign country or countries during at least 510 full days during any period of 18 consecutive months, but receives compensation attributable to such period in a taxable year ending subsequent to December 31, 1952, no portion of which falls within the 18-month period, no portion of such compensation received in such taxable year is excludable from his gross income.

No. 18,239

IN THE

United States Court of Appeals

For the Ninth Circuit

S. H. KRESS & CO.,
Petitioner,

vs.

NATIONAL LABOR RELATIONS BOARD,
Respondent.

On Petition to Review and Set Aside an Order of the National Labor Relations Board

REPLY BRIEF FOR S. H. KRESS & CO.

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Subject Index

Table of Authorities Cited

Cases

Statutes

No. 18,239

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REPLY BRIEF FOR S. H. KRESS & CO.

The Board's Decision and Order in this case must stand or fall on its own two feet. The arguments presented in the brief filed by the General Counsel for the Board do not strengthen, support or validate the decision of the Board itself. All of the points discussed in the Board's brief have been met and answered in Petitioner's opening brief. However, this short reply may serve to narrow the issues and facilitate the Court's review.

1. THE "REASONABLE TENDENCY" TEST SET FORTH IN THE BOARD'S BRIEF IS INAPPOSITE.

Interrogation by an employer of his employees with respect to their union membership or activity is not unlawful per se on the theory that it necessarily tends to interfere with or coerce the employees.

(a) The cases cited in Petitioner's opening brief (pages 26-47) indicate that there must be *actual* interference, restraint or coercion, based upon a background of antiunion activity, threats of reprisal, promises of benefit, or an overall pattern of illegal conduct.

(b) The decisions of this Court are in accord. In *NLRB v. McCatron,* 216 F.2d 212 at 216, it is stated without qualification that:

> "Interrogation regarding Union activity does not in and of itself violate Section 8(a)(1)."

That proposition was reaffirmed by this Court in *NLRB v. Roberts Bros.,* 225 F.2d 58 and has been cited and quoted with approval in the more recent case of *NLRB v. Sebastopol Apple Growers,* 269 F.2d 705.

In the *McCatron* case, this Court stated the test to be whether the interrogation alleged to be unlawful, contained "an express or implied threat or promise" or formed "part of an overall pattern whose tendency is to restrain or coerce." (216 F.2d at 216.)

Citation in the Board's brief of prior decisions of this Court, and reliance thereon, is misplaced. In *NLRB v. West Coast Casket Co.,* 205 F.2d 902, the interrogation of employees found to be unlawful was

accompanied by promises of economic benefits intended to influence the employees against unionization. In that case the employer, in addition to interrogating employees, committed the following acts: threatened to discharge employees who refused to cross the Union picket line; threatened to close the plant if the Union succeeded in organizing the employees; promised employees wage increases and an improved insurance program; actually discharged an employee for the purpose of discouraging union membership; and actually granted wage increases to three of the employees who were interrogated. In the *McCatron* case, this Court expressly pointed out that the interrogation in *West Coast Casket* "occurred against a background of coercive conduct."

The quotation on page nine of the Board's brief from this Court's decision in *NLRB v. Essex Wire Corp.,* 245 F.2d 589 refers to the employer's demand that an employee turn over to the company signed Union membership cards that he had obtained from other employees. Thereupon the employee, who had been ordered to bring the cards to the company office "in five minutes," immediately "returned the cards to the employees who had signed them." This Court held that "the demand that the Union cards be delivered to the foreman" was a violation of Section 8(a)(1). Obviously, such fact situation is quite different from that in the instant case.

Similarly, in *NLRB v. State Center Warehouse,* 193 F.2d 156, cited on page 11 of the Board's brief, the interrogation of employees found by this Court to

be unlawful was part of an overall pattern of conduct which included threats of closing the plant if employees joined the Union, threats of discharging employees for Union membership, and the actual discharge of one employee for that very reason.

Since the instant case contains no threats or promises, no background of antiunion animus and no overall pattern of coercive conduct, it is governed by the princples laid down by this Court in such cases as *Wayside Press,* 206 F.2d 862; *McCatron,* supra; *Roberts Bros.,* supra; and *Sebastopol Apple,* supra.

(c) Moreover, the so-called "reasonable tendency" test is not the position which was taken by the Board in its decision in the instant case. The basis of the Board's decision is its legal conclusion that petitioner's interrogation was not carried on for a legitimate purpose (see discussion below under point 2). Nothing in the Board's decision indicates that it was proceeding on a theory of "natural or reasonable tendency."

In this connection, it is noteworthy that the Board's brief on page seven states:

> "In banning 'interference' Congress clearly meant to proscribe *any* employer activity which would tend to limit employees in the exercise of their statutory rights." (Emphasis added.)

But on page 11 of the Board's brief the following statement is made:

> "This is not, of course, to say that *any* effort by an employer to ascertain the union sentiments

of his employees will *necessarily* be violative of the Act." (Emphasis added.)

It is respectfully submitted that the Board's brief, in seeking to uphold the Board's position, obscures the main issue which is the legality of petitioner's purpose and the totality of conduct involved.

---

2. THE REAL BASIS OF THE BOARD'S DECISION IS ITS CONCLUSION THAT PETITIONER'S INTERROGATION OF EMPLOYEES DID NOT HAVE A LEGITIMATE PURPOSE.

In discussing petitioner's investigation of the Union's showing of interest, the Board stated flatly:

> "Interrogation, conducted for such purpose, serves no useful function and is not conducted for a purpose 'legitimate in nature.' " (R. 21)

Later in its opinion, the Board refers to:

> "* * * our conclusion that no useful or legitimate purpose is served or can be served by systematic employer interrogation undertaken for the purpose of investigating the adequacy of a petitioner's showing of interest." (R. 22-23)

That the Board's decision depends entirely upon the purpose of petitioner's interrogation is further made clear by its reference to its previous decision in the *Blue Flash* case, 109 NLRB 591. Referring to that case, the Board states:

> "The Board there held that such interrogation, *conducted for a 'purpose legitimate in nature'* * * * did not tend to restrain or interfere with employees' exercise of rights guaranteed by the

Act *simply because of the systematic nature of the interrogations.*" (R. 20; emphasis added.)

Thus, the argument in the Board's brief that petitioner's purpose is immaterial to the consideration of this case is patently erroneous.

---

3. **THE BOARD FOUND THAT PETITIONER'S PURPOSE WAS NOT LEGITIMATE BECAUSE IT RELATED TO THE UNION'S SHOWING OF INTEREST RATHER THAN THE UNION'S MAJORITY STATUS.**

(a) This distinction is without foundation or merit. The two purposes are interrelated. Petitioner's ultimate purpose was to ascertain the Union's majority status. Its immediate purpose was to determine the Union's showing of interest. Obviously, if the Union did not represent 30 per cent of the employees, it did not represent a majority. Petitioner undertook its interrogation *only after* a substantial number of employees voluntarily reported to management that they did not believe that the Union had secured authorizations from 30 per cent of the employees. Contrary to the assertion in the Board's brief (page 5, footnote 7), this is not an argument advanced by petitioner; *it is a fact* contained in the stipulation submitted to the Board. (Stipulation of Facts, page 4, paragraph IX, R. 11.)

(b) While it is true that in the *Blue Flash* case, supra, the Union had made an express and direct demand upon the employer for recognition, no such demand or claim of representation was made by the

Union in *NLRB v. California Compress Co.,* CA 9, 274 F.2d 104; *NLRB v. Firedoor Corp.,* CA 2, 291, F.2d 328; *NLRB v. Crystal Laundry,* CA 6, 308 F.2d 626, referred to in Petitioner's opening brief. Nothing in the Court decisions indicate that interrogation is unlawful per se *unless* it is preceded by a Union claim of representation and demand for recognition.

In fact, in *Crystal Laundry* the Union had neither demanded recognition *nor* filed a petition for election. Yet the systematic and repeated polling of employees as to their Union membership and activity was held lawful in that case, even though the employer engaged in a vigorous expression of antiunion animus and took no steps to assure the employees against reprisals.

In *California Compress* this Court held interrogation unlawful because it was accompanied by threats of reprisal *and* because its purpose was to undermine the Union, not to challenge the validity of the Union's showing of interest. This Court's decision was *not based* upon the fact that the Union had not made an express, direct demand for recognition upon the employer but had simply filed a petition for election with the Board.

Notwithstanding the arguments in its brief (page 13, footnote 16) the Board itself has repeatedly held that the "filing itself" of a petition for election by a Union constitutes a "sufficient" demand for recognition. See *Florida Tile,* 130 NLRB No. 103; *Tyree's Inc.,* 129 NLRB 1500.

Section 9(c)(1)(A) of the Act refers to the filing of a petition by a Union as alleging that the employer

declines to recognize the Union "*as the representative* (of employees) *as defined in section 9(a)*" (Emphasis added, see Appendix.)

Section 9(a) provides that: "Representatives designated or selected * * * by the *majority* of the employees in a unit appropriate * * * shall be the *exclusive representative* of all the employees in such unit * * *" (Emphasis added, see Appendix.)

Thus, the statute itself expressly contemplates that the filing of a petition for election by a Union constitutes an assertion of majority status and a demand for recognition as exclusive bargaining representative.

---

4. **THE BOARD'S POSITION THAT AN EMPLOYER HAS NO LEGITIMATE PURPOSE IN QUESTIONING A UNION'S SHOWING OF INTEREST IS ERRONEOUS AS A MATTER OF LAW.**

This is the key issue in the case.

In its brief, the Board seeks to defend its position on the grounds that such interrogation usurps the Board's function and authority; invades the employees' right of privacy; conflicts with the Board's administrative rule against litigating the issue of showing of interest; and could lead to retaliation and discrimination.

None of the foregoing reasons meets the test laid down by the courts on the legality of interrogation.

The Board's contention that no useful purpose can be served by such interrogation is directly contrary to its own decisions in which election petitions filed by Unions were dismissed upon evidence submitted by

employers successfully challenging the Union's showing of interest. See *Globe Iron Foundry,* 112 NLRB 1200; *Columbia Records,* 125 NLRB 1161.

Moreover, the Board's brief is incorrect in characterizing the showing of interest rule as simply an "administrative expedient" to save the government time, effort and money. As the Board's own decisions show, the rule in question is not merely an administrative requirement to be applied by the Regional Offices in determining whether to investigate the petition, schedule a hearing, and otherwise process the case. It is regarded by the Board as a *condition precedent* for directing ard holding the election itself, *even where,* after a hearing, all of the other necessary elements have been found to exist. (See *Tyree's Inc.,* supra, at 1503, footnote 8; *Swift & Co.,* 127 NLRB 87 at 88, footnote 2.)

In terms of usurping the Board's authority, is not subjecting employees to systematic, private polls conducted by an employer, with none of the safeguards which are part of the Board's secret ballot procedures, a much more substantial infringement of the Board's function, to say nothing of an invasion of employees' privacy? Nevertheless, such conduct has repeatedly been held lawful both by the Board and the courts. (See Petitioner's opening brief, pages 32-33.)

For example, in the *Crystal Laundry case,* supra, the employer polled his employees on four separate, successive occasions, even though the results of each poll were unanimously or overwhelmingly against the Union. What justification existed for each additional

instance of interrogation? What useful purpose was to be served?

How can the Board's decision in the instant case be reconciled with its recent decision in *Philanz Oldsmobile, Inc.,* 137 NLRB No. 103 (discussed in Petitioner's opening brief, pages 48-50), where a strike was held lawful even though the conceded purpose was to compel the employer, by economic force and coercion, to agree to a "consent" election instead of proceeding with a hearing before the Board. The dissenting opinion in that case pointed out, in effect, that such conduct by the Union clearly usurped the function and authority of the Board.

Finally, in *California Compress Co.,* supra, this Court has clearly indicated that interrogation by an employer "to check the authenticity of the Union's claim of interest" or "to gather evidence to assist the Board in determining the authenticity of the showing of interest made by the Union" is *not unlawful per se.* Nothing in the Court's decision in that case suggests that such purpose cannot be "legitimate in nature."

In *California Compress,* this Court sustained the Board's finding that the purpose of the interrogation was to undermine the Union, and not to ascertain the validity of the Union's showing of interest, on the basis of substantial evidence showing that the interrogation was conducted in an atmosphere of explicit threats of reprisal and actual coercion. The overall pattern of the interrogation in that case showed hostility to the Union and was accompanied by threats to discharge every employee who had signed a Union card.

When an employer, in interrogating employees, tells them that he is informed that about 50 out of 86 have signed up with the Union, that he intends to find out who they are, and that if he finds out, he will fire every one of them, there is no question but that this Court must sustain a finding that the purpose of such interrogation is to undermine the Union and not to challenge the Union's showing of interest.

But there is no such evidence in the instant case. The facts in the instant case resemble those in *Blue Flash,* supra, and the various decisions of this Court and other courts (cited in Petitioner's opening brief) where interrogation occurred against background free of employer hostility to Union organization, where the employer assured the employees that there would be no economic reprisals, and where no threats or promises were made.

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5. THE BOARD HAS IMPROPERLY TAKEN A "PER SE" APPROACH IN THIS CASE.

The "per se" approach in cases involving interrogation of employees has been unequivocally rejected by this Court and virtually all of the Courts of Appeals. (See *NLRB v. Roberts Bros.,* supra.)

Although a "per se" approach is disclaimed in the Board's brief, it is perfectly plain the Board's decision that it is taking the position that interrogation for the purpose of challenging or ascertaining the validity of a Union's showing of interest is unlawful per se. After concluding that such purpose is not

legitimate, the Board expressly states that such interrogation "*necessarily* tends to interefere with and restrain employees * * * and to interfere with the election processes of the Board." (R. 23) (See point 2, above.)

This can only be characterized as a "per se" approach. It is clearly inconsistent with the "totality of conduct" test formulated by the Board in its *Blue Flash* decision.

What are the circumstances which comprise a "totality of conduct"? They are the answers to such questions as *who, what, when, where* and *how.*

With respect to the circumstance "*Who,*" the assertion in the Board's brief (pages 10 and 12, footnote 15) that only "casual, perfunctory interrogation by minor supervisory employees" has been held lawful is completely erroneous. The cases cited in Petitioner's opening brief (pages 26-47) involved not only store managers, personnel directors, department managers, district managers and shop superintendents, but also plant superintendents, general managers, presidents, vice presidents and partners.

With respect to the circumstance "*What,*" the stipulated record shows that petitioner made no threats, promises or any coercive an antiunion statements at all.

With respect to the circumstance "*When,*" the interrogation occurred during the ordinary working day and did not intrude upon the employees' own time.

With respect to the circumstance "*Where,*" the record shows that the employees were *not called* into the manager's office. Nor were they approached in their own homes.

With respect to the circumstance "*How,*" the stipulated record shows that Petitioner took all possible affirmative steps to assure the employees against any fear of reprisals. The purpose of the interrogation was communicated to the employees; they were expressly told that they were under no obligation to answer any questions or to give any information. In fact, the employees were told that they were free to leave at any time, and they could have left immediately, even before they were questioned. Moreover, Petitioner made no statements about the Union and did not ask the employees to make any statements about the Union. There is no antiunion animus in this case, and none was found by the Board.

Finally, it is noteworthy that nothing in the complaint issued by the General Counsel of the Board alleges that the manner in which the interrogation was conducted constitutes a violation of the Act.

CONCLUSION

Obviously, this case can only be decided in terms of the *purpose* of the interrogation and the *circumstances* under which it was conducted. That is the substance of the test laid down by this Court in the *McCatron* case.

For all of the foregoing reasons, it is respectfully submitted that petitioner's purpose was legitimate and that the circumstances were not coercive. Therefore, the petitioner's conduct was lawful, and the Board's finding of a violation should be set aside.

Dated, San Francisco, California,
March 25, 1962.

Respectfully submitted,
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ROBERT J. SCOLNIK,
By ROBERT L. SCOLNIK,
Attorneys for S. H. Kress & Co.

(Appendix Follows)

Appendix.

Appendix

LABOR MANAGEMENT RELATIONS ACT, 1947, AS AMENDED

SEC. 9. (a) Representatives designated or selected for the purposes of collective bargaining by the majority of the employees in a unit appropriate for such purposes, shall be the exclusive representatives of all the employees in such unit for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment: Provided, That any individual employee or a group of employees shall have the right at any time to present grievances to their employer and to have such grievances adjusted, without the intervention of the bargaining representative, as long as the adjustment is not inconsistent with the terms of a collective-bargaining contract or agreement then in effect: Provided further, That the bargaining representative has been given opportunity to be present at such adjustment.

* * * * * * *

(c) (1) Whenever a petition shall have been filed, in accordance with such regulations as may be prescribed by the Board—

(A) by an employee or group of employees or any individual or labor organization acting in their behalf alleging that a substantial number of employees (i) wish to be represented for collective bargaining and that their employer declines to recognize their representative as the repre-

sentative defined in section 9 (a), or (ii) assert that the individual or labor organization, which has been certified or is being currently recognized by their employer as the bargaining representative, is no longer a representative as defined in section 9 (a); or

(B) by an employer, alleging that one or more individuals or labor oganizations have presented to him a claim to be recognized as the respresentative defined in section 9 (a);

No. 18239

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S. H. KRESS & CO., PETITIONER

v.

NATIONAL LABOR RELATIONS BOARD, RESPONDENT

On Petition for Review And On Cross-Petition for Enforcement of An Order of the National Labor Relations Board

BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

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INDEX

AUTHORITIES CITED

Cases:

Cases—Continued Page

Cases—Continued

Statute:

Miscellaneous: Page

In the United States Court of Appeals for the Ninth Circuit

No. 18239

S. H. KRESS & CO., PETITIONER

v.

NATIONAL LABOR RELATIONS BOARD, RESPONDENT

On Petition for Review And On Cross-Petition for Enforcement of An Order of the National Labor Relations Board

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BRIEF FOR THE NATIONAL LABOR RELATIONS BOARD

JURISDICTION

This case is before the Court upon petition of S. H. Kress & Co. to review an order (R. 16-26)[1] of the National Labor Relations Board, issued against it on July 11, 1962, following proceedings under Section 10 of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C. Sec. 151, *et*

[1] References to the pleadings reproduced as "Pleadings, Volume I" are designated "R." References preceding a semicolon are to the Board's findings; those following, to the supporting evidence.

seq.).[2] In its answer the Board requests enforcement of its order.

The Board's decision and order are reported at 137 NLRB No. 126. This Court has jurisdiction of the proceedings under Section 10(e) and (f) of the Act, the unfair labor practices having occurred at petitioner's retail store in Stockton, California.

COUNTERSTATEMENT OF THE CASE

I. The Board's findings of fact

Briefly, the Board found that petitioner, by engaging in systematic interrogation of its employees as to their Union[3] membership, and by seeking to induce employees who admitted to having signed Union authorization cards to revoke such authorization, had violated Section 8(a)(1) of the Act. The relevant underlying facts, all of which have been stipulated by the parties (R. 8-14),[4] are as follows:

On August 2,[5] the Union filed a petition with the Board's Regional Office in San Francisco, seeking a

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[2] The pertinent provisions of the Act are set forth *infra*, pp. .

[3] Teamsters, Chauffeurs, Warehousemen & Helpers, Local 439, International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America.

[4] The parties, in addition to entering into a stipulation of facts, waived their right to a hearing before a Trial Examiner, and jointly moved to transfer proceedings directly to the Board for findings of fact, conclusions of law, and decision and order. The Board granted the joint motion (R. 15, 16-17).

[5] All dates herein are 1961.

representation election in a 60-employee unit at petitioner's store in Stockton, California. On September 12, after negotiations for a consent election had proved fruitless, the Regional Director of the Board issued a notice that a hearing would be held on September 27 on the Union's petition for an election (R. 17-18; 9).

On September 15 and 16, petitioner's store manager, Glenn E. Greenbank, and its labor relations representative, Charles G. Barry, interviewed 46 of the employees in the proposed unit. Each employee was called separately into a storeroom area and there interviewed by Greenbank and Barry. The interviews were conducted during working hours and the employees were paid for the time spent at the interview. (R. 18; 9-10). In the course of the individual interviews, each employee was told that petitioner wanted to determine whether the Union had obtained the signatures of enough employees, 30 percent of those in the proposed unit, to support its petition.[6] Each employee was assured that his job was not endangered and that he could speak freely. Each was told that it was not petitioner's intention to inquire into his feelings for or against the Union, that he was under

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[6] The Board has long followed the practice of requiring a petitioning union to make a *prima facie* showing of at least 30 percent representation in the proposed unit as a condition precedent to the conduct of a representation election. See National Labor Relations Board Rules and Regulations and Statements of Procedure Series 8, Section 101.17-101.18 (Appendix A to petitioner's brief); see also *N.L.R.B.* v. *J. I. Case Co.*, 201 F. 2d 597, 598-600 (C.A. 9).

no obligation to discuss those feelings, that he was not required to furnish any information to petitioner, and that he was free to leave at any time. (R. 18; 10.)

Each employee was then handed a mimeographed form, which read as follows:

S. H. KRESS & Co.

Stockton, California

I have not signed a card for the union to represent me as an employee of S. H. Kress & Co.

Dated ..... Signed .....
(Employee)

Each employee was asked to read the form, and was told that he could sign it or not as he wished; that the matter was confidential and would not affect his job. Forty employees signed such forms. One stated she had not signed an authorization card, but would not sign the form. Five, upon stating that they had signed authorization cards, were asked by petitioner if "they were sure what it meant." All replied that they did not, whereon petitioner suggested that if they wished to revoke their authorizations, they could so indicate on the mimeographed form. Four did so, signing the form and adding the following statement on the bottom: "I signed a card but would like to have it revoked." One signed and added: "At the time I signed the card I was unaware of the purpose of the card." During the interviews, petitioner expressed no opinion about the Union, or union organization, and none of the employees made any protest

or indicated any objection to any statements made or questions asked. (R. 18-19; 10-11.)[7]

On September 19, Barry forwarded the 45 signed forms to the Regional Director, requesting him to reinvestigate the Union's showing of interest. The Regional Director did so and concluded that some of the signed forms obtained by the Company during the systematic interrogation of its employees were false. Accordingly, the Regional Director notified the Company that the Union's showing of interest was adequate and proper. Subsequently, on October 26, upon charges previously filed by the Union, the Regional Director issued a complaint, alleging that petitioner had violated Section 8(a)(1) by its interrogation of September 15 and 16 (R. 19; 11-12).[8]

II. The Board's conclusions and order

On the foregoing facts the Board concluded that by interrogating employees as to their union membership, and by seeking to induce employees who ad-

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[7] According to petitioner, the above-described interviews took place after approximately 13 employees had voluntarily reported to Greenbank and other supervisors that they did not believe that 30 percent of the employees had signed authorization cards (R. 19-20; 11).

[8] On August 9, the Union had filed charges with the Board, alleging that petitioner had engaged in unlawful interrogation of its employees. Those charges were withdrawn on August 24, with the approval of the Regional Director (R. 17; 9). On September 25, the Regional Director notified all the parties that: "Upon the basis of newly discovered evidence, the withdrawal request heretofore approved August 24, 1961, is hereby revoked and the case is reopened for further investigation." (R. 19; 12.)

mitted to having signed union authorization cards to revoke such authorization, petitioner had interfered with, restrained, and coerced its employees in the exercise of their rights under Section 7, thereby violating Section 8(a)(1) of the Act (R. 24). The Board's order requires petitioner to cease and desist from the unfair labor practices found and from like or related violations of the Act. Affirmatively, the Board's order requires petitioner to post appropriate notices (R. 24-25.)

ARGUMENT

THE BOARD PROPERLY FOUND THAT PETITIONER UNLAWFULLY INTERROGATED ITS EMPLOYEES AND SOUGHT TO INDUCE THEM TO REVOKE UNION AUTHORIZATION CARDS, THEREBY VIOLATING SECTION 8(a)(1) OF THE ACT

A. Petitioner's conduct violated Section 8(a)(1) of the Act

The fundamental purpose of the National Labor Relations Act is to encourage collective bargaining and to protect "the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing, for the purpose of negotiating the terms and conditions of their employment or other mutual aid or protection." Section 7 implements this purpose by guaranteeing employees the "right" to engage in such activity and Section 8(a)(1) enforces the guarantee by declaring it to be an unfair labor practice for an employer "to interfere with, restrain, or coerce" employees in the

exercise of their rights under Section 7. The language and legislative history of Section 8(a)(1) show that Congress intended the terms "interfere," "restrain," and "coerce" to have separate and distinct meanings.[9] In banning "interference" Congress clearly meant to proscribe any employer activity which would tend to limit employees in the exercise of their statutory rights.[10] No actual interference with employee rights need be shown to make out a violation of Section 8(a)(1). "The test is whether the employer engaged in conduct which, it may reasonably be said, tends to interfere with the free exercise of employee rights under the Act." *N.L.R.B.* v. *Illinois Tool Works*, 153 F. 2d 811, 814 (C.A. 7). See also *N.L.R.B.* v. *Ford*, 170 F. 2d 735, 738 (C.A. 6); *N.L.R.B.* v. *Syracuse Color Press*, 209 F. 2d 596, 599 (C.A. 2), cert. den., 347 U.S. 966; *Time-O-Matic*,

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[9] See Senate Committee on Education and Labor, Hearings on S. 1958, 74th Cong., 1st Sess. (1935) pp. 713-714, 558; 305; H.R. No. 245 on H.R. 3020, 80th Cong., 1st Sess. (1947) p. 28.

[10] Looking back after 4 years of experience under the Wagner Act, at a time when amendments to Section 8(a)(1) were urged but not adopted, Senator Wagner made this observation on the need for continuing the prohibition against interference:

> The ban against "interference" has been of central importance in protecting the right to organize . . . since it embraces a multitude of activities which would not be reached by specific prohibitions written into law, and would not be included within the range of such narrower concepts as "restraint" or "coercion." 84 Cong. Rec., 76th Cong., 1st Sess. (1939) A. 2053.

Inc. v. *N.L.R.B.*, 264 F. 2d 96, 99 (C.A. 7); *Blue Flash Express*, 109 NLRB 591, 593. Accord, *N.L.R.B.* v. *Link-Belt Co.*, 311 U.S. 584, 588, 599.[11]

Employees can exercise fully their statutory right to engage in self-organizational and other concerted activity only if they are free from employer prying and investigation. For, when an employer inquires into organizational activity, whether by surveillance or direct questioning, the employee who is interrogated or watched will naturally fear that the employer not only wants information on the nature and extent of his union interests and activities, but also contemplates some form of reprisal once the information is obtained. Thus, as this Court has noted, "Interrogation as to union sympathy and affiliation has been held

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[11] Similarly, evidence of unlawful intent on the part of the employer is not a necessary element of proof of violation of Section 8(a)(1). "It is the effect and not the motivation of [petitioner's] action which determines whether he has violated Section 8(a)(1)." *N.L.R.B.* v. *Price Valley Lumber Co.*, 216 F. 2d 212, 215 (C.A. 9). Thus, petitioner's assertion (Brief, pp. 17-23) that the evidence does not show that it interrogated its employees for an unlawful purpose is, even if correct, irrelevant. Nor is it made relevant by the allegation in the complaint that the purpose of petitioner's interrogation was to undermine the Union and to interfere with, restrain or coerce its employees. For, in this context, it is plain that an allegation of unlawful motive on petitioner's part means no more than that the natural consequence of its interrogation was to interfere with its employees' rights under the Act. "This recognition that specific proof of intent is unnecessary where employer conduct inherently encourages or discourages union membership is but an application of the common-law rule that a man is held to intend the foreseeable consequences of his conduct. . . ." *Radio Officers' Union* v. *N.L.R.B.*, 347 U.S. 17, 45.

to violate the Act because of its natural tendency to instill in the minds of employees fear of discrimination on the basis of the information the employer has obtained." *N.L.R.B.* v. *West Coast Casket Co.*, 205 F. 2d 902, 904. "Whether the company would be disposed to make such use of the [information] is beside the point. As long as the opportunity is present, employees may have a real fear that this would be done." *N.L.R.B.* v. *Essex Wire Corp. of Calif.*, 245 F. 2d 589, 592 (C.A. 9).

That petitioner's conduct in the instant case would tend to create such a fear in its employees, and so interfere with their rights of self-organization, is clear. Petitioner systematically inquired of 46 employees as to whether each had signed a union card by soliciting the signature of each to a mimeographed form stating that the employee had not signed such a card. The very wording of the form, inviting as it did, a plainly negative response, made petitioner's antiunion animus plain to the employees. Cf. *N.L.R.B.* v. *California Compress Co.*, 274 F. 2d 104, 106 (C.A. 9). Forty of the employees signed the mimeographed forms, though it was later determined that some of them had signed union authorization cards (R. 22, 19; 11); this alone is some indication of the fear engendered in the employees that petitioner's questions were but the prelude to retaliatory activity. See *N.L.R.B.* v. *Syracuse Color Press*, 209 F. 2d 596, 599-600 (C.A. 2), cert. den., 347 U.S. 966. Moreover, when five of the employees admitted having signed union cards, petitioner sought to induce them to revoke such cards, thus

reemphasizing its opposition to union organization.[12] Finally, it should be noted that the interrogators were not minor supervisory employees, but petitioner's store manager and its labor relations representative. The participation of such high managerial representatives in the interrogation is a potent factor in creating the "aroma of coercion" condemned in the Act. *Joy Silk Mills* v. *N.L.R.B.*, 185 F. 2d 732, 740 (C.A.D.C.), cert. den., 341 U.S. 914. See also *N.L.R.B.* v. *Syracuse Color Press, supra,* at 599. In sum, we submit that the systematic interrogation of employees as to their union membership, by representatives of high management, in circumstances which belie the employer's professed unconcern with the union affiliation of its employees, infringes upon the employees' right to privacy in their union affairs,[13] and is unlawful because of

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[12] The Board found, in accord with settled law, that such inducement of employees to revoke union authorization cards previously signed by them was in and of itself a violation of Section 8(a)(1) of the Act. *N.L.R.B.* v. *Howard-Cooper Corp.*, 259 F. 2d 558 (C.A. 9); *N.L.R.B.* v. *Parma Water Lifter Co.*, 211 F. 2d 258 (C.A. 9), cert. den., 348 U.S. 829; *N.L.R.B.* v. *United Biscuit Co.*, 208 F. 2d 52 (C.A. 8), cert. den., 347 U.S. 934; *N.L.R.B.* v. *Lovvorn,* 172 F. 2d 293 (C.A. 5); *N.L.R.B.* v. *Consolidated Machine Tool Co.,* 163 U.S. 376 (C.A. 2), cert. den., 332 U.S. 824.

[13] Though petitioner denies that employees have a right to privacy in their union affairs, the existence of such a right, as a necessary concomitant to the full and free exercise of the organizational rights guaranteed by Section 7 of the Act, has long been recognized. See *N.L.R.B.* v. *Grower-Shipper Vegetable Association of Central California, Inc.,* 122 F. 2d 368, 376, in which this Court found an employer to have violated the Act by surveillance of employee organizational activity, even though the employees involved were unaware

its "natural tendency to instill in the minds of employees fear of discrimination on the basis of the information the employer has obtained." *N.L.R.B.* v. *West Coast Casket, supra.* See also *N.L.R.B.* v. *California Compress Co., supra; N.L.R.B.* v. *State Center Warehouse,* 193 F. 2d 156 (C.A. 9); *N.L.R.B.* v. *Syracuse Color Press, Inc., supra; N.L.R.B.* v. *F. H. McGraw & Co.,* 206 F. 2d 635 (C.A. 6); *Spartanburg Sportswear Co.,* 116 NLRB 1914, enf'd, 246 F. 2d 366 (C.A. 4).

This is not, of course, to say that any effort by an employer to ascertain the union sentiments of his employees will necessarily be violative of the Act. As this Court stated in *N.L.R.B.* v. *Roberts Brothers,* 225 F. 2d 58, 60, the question of whether a poll of employees as to their union affiliation is unlawful depends on the circumstances of each case. But in *Roberts,* in *N.L.R.B.* v. *Protein Blenders, Inc.,* 215 F. 2d 749 (C.A. 8), and in *N.L.R.B.* v. *Crystal Laundry,* 308 F. 2d 626 (C.A. 6), on all of which petitioner relies, the poll involved was a secret one. Here, each employee was interrogated individually,[14] and, fur-

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of the surveillance, so that it could have had no restrictive effect on the continuance of such activity. See also *N.L.R.B.* v. *Clark Bros. Co.,* 163 F. 2d 373, 375 (C.A. 2); *N.L.R.B.* v. *Baldwin Locomotive Works,* 128 F. 2d 39, 50 (C.A. 3); *Bethlehem Steel Co.* v. *N.L.R.B.,* 120 F. 2d 641, 647 (C.A.D.C.); *Premier Worsted Mills,* 85 NLRB 985, 986; *Virginia Electric and Power Co.,* 44 NLRB 404, 426, 427, enforced, 132 F. 2d 390 (C.A. 4), affirmed, 319 U.S. 533.

[14] We totally fail to understand petitioner's assertion (Brief, p. 38, n. 40) that a "private" or secret poll is more

thermore, the mimeographed form presented to each employee had "an anti-union sound about it." *N.L.R.B.* v. *California Compress Co.*, *supra*, at 106. The instant case is thus distinguishable from *Roberts*, *Protein Blenders*, and *Crystal Laundry*, and is much more akin to *California Compress* in which this Court found the Act to have been violated by the employer's circulation of, and effort to obtain signatures to, an affidavit denying that the signer had executed a union authorization card.[15]

B. Petitioner's defenses are without merit

Petitioner's assertion that its conduct was lawful under the Board's decision in *Blue Flash Express*, 109 NLRB 591, is wholly lacking in merit. In that case, the union involved had gone directly to the employer, claimed majority status, and requested the employer to bargain with it (*id.* at 592). The employer's sub-

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likely to have a coercive effect than face-to-face questioning. The contrary assumption would appear far more warranted. See *California Compress, supra; N.L.R.B.* v. *Crystal Laundry, supra,* at 628; *N.L.R.B.* v. *Protein Blenders, Inc., supra,* at 751; *N.L.R.B.* v. *Colten,* 105 F. 2d 179, 181-182 (C.A. 6).

[15] An examination of the cases cited by petitioner on pages 26-31 of its brief shows that they differ factually from the instant case. By and large, they exemplify the casual, perfunctory interrogation by minor supervisory employees that comes within the doctrine of *Sax* v. *N.L.R.B.* (cited by petitioner as *Container Mfg. Co.* v. *N.L.R.B.*), 171 F. 2d 769 (C.A. 7), relied on by this Court in *Wayside Press* v. *N.L.R.B.*, 206 F. 2d 862. In none of those cases was there the systematic inquiry by high management officials here presented. See *N.L.R.B.* v. *Syracuse Color Press, Inc., supra,* at 599; *N.L.R.B.* v. *F. H. McGraw & Co., supra,* at 640.

sequent questioning of his employees for "a purpose which was legitimate in nature" (*id.* at 593), i.e., to determine whether the union did in fact represent a majority of his employees and accordingly whether he was legally obligated to recognize and bargain with the union, was held by the Board to be lawful. Here, on the other hand, petitioner was faced with no such bargaining demand, but merely with a petition for a representation election. Thus, even assuming that petitioner's ultimate purpose in interrogating its employees was, as it asserts, to determine the Union's majority status, that purpose does not serve to legitimize the interrogation. For in the absence of a direct claim of majority status and a demand that petitioner bargain with the Union, petitioner had no such pressing need to know whether the Union did in fact represent a majority of its employees that it could not await the results of the forthcoming representation election.[16] In brief, the rationale of *Blue Flash*—that an employer faced with a direct claim of majority status and a request for bargaining may legitimately question his employees to determine whether he must,

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[16] A mere petition for a representation election is obviously not the same thing as a bargaining demand, nor do the cases cited by petitioner (Brief p. 4, n. 5) hold otherwise. The teaching of those cases is simply that the filing of a representation petition constitutes a statutorily sufficient demand for recognition to enable the Board to proceed under Section 9(c)(1) to investigate and determine whether a question of representation exists. *Tyree's, Inc.*, 129 NLRB 1500, n. 1. The filing of such a petition does not, however, obligate the employer to bargain with the petitioning union unless and until an election establishes its majority status.

as a matter of law, bargain with the union—is inapplicable here where the Union neither claimed majority status nor demanded that petitioner recognize and bargain with it.[17]

Nor may petitioner bring its conduct within *Blue Flash* by asserting that it had a legitimate concern with whether the Union had achieved a proper showing of interest. The Board's showing of interest rule was adopted as an administrative expedient to enable the Board to eliminate representation petitions with little or no prospect of success in order to avoid needless dissipation of the Government's time, effort, and funds in conducting representation elections in such circumstances. *O. D. Jennings & Co.*, 68 NLRB 516, 517-518; *N.L.R.B.* v. *J. I. Case Co.*, 201 F. 2d 597 (C.A. 9). An integral and long accepted concomitant of the showing of interest rule is the non-litigability of a petitioner's evidence as to such interest. *N.L.R.B.* v. *J. I. Case Co.*, 201 F. 2d 597, 599-600 (C.A. 9); *N.L.R.B.* v. *National Truck Rental Co.*, 239 F. 2d 422 (C.A.D.C.), cert. den., 352 U.S. 1016; *Kearney*

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[17] Both *Bon-R Reproductions, Inc.* v. *N.L.R.B.*, 309 F. 2d 898 (C.A. 2) and *N.L.R.B.* v. *Firedoor Corp.*, 291 F. 2d 328, cert. den., 368 U.S. 921, are distinguishable from the instant case in that, in those cases, as in *Blue Flash*, the employer's questioning of his employees was for a legitimate purpose. Thus, the interrogation found in those cases to be lawful came after the union had made a direct claim of majority status, and was based on the employer's need to know whether he was obligated to recognize and bargain with the union. Similarly, in *N.L.R.B.* v. *Katz Drug Co.*, 207 F. 2d 168 (C.A. 8), also relied on by petitioner, the employer had a valid purpose for his interrogation, i.e., to prepare for pending litigation.

& Trecker Corp. v. *N.L.R.B.*, 209 F. 2d 782, 786-788 (C.A. 7); *N.L.R.B.* v. *White Construction & Engineering Co.*, 204 F. 2d 950, 953 (C.A. 5). The Board reserves to itself the function of investigating such claims, and in its investigation it endeavors to keep the identity of the employees involved secret from the employer and from other participating labor organizations. It does so both because of its statutory responsibility for investigation of questions concerning representation and, equally significantly, because the disclosure of the identity of the employees involved to other parties tends to destroy the secrecy of the ballot and the integrity of the Board's processes. (R. 21.) Cf. *N.L.R.B.* v. *J. I. Case Co.*, *supra*, at 600, in which this Court indicated that the substantiality of a union's showing of interest is a matter of administrative concern only and warned against "disclosure of the individual employees desires with respect to representation [which] would violate the long-established policy of the secrecy of the employees' choice in such matters." To accept petitioner's argument that, despite the conceded non-litigability of a union's showing of interest, it was here justified in engaging in systematic interrogation of its employees as a means of determining whether an adequate showing of interest had been achieved would be to sanction the very forced disclosure of employee participation in union organizational activity which the non-litigability doctrine is intended to prevent. It would, in sum, be to "permit a rule adopted for [the Board's] own convenience as an administrative expedient to be turned into a procedure

by which an employer can inform itself of the identity of employee leaders of organizational campaigns" (R. 21).[18]

Finally, petitioner's reliance on *Globe Iron Foundry*, 112 NLRB 1200, and *General Shoe Corp.*, 114 NLRB 381, as justifying its investigation of the Union's showing of interest is wholly misplaced. Nothing in those decisions suggests that the employers composed or circulated the statements there involved, much less that they systematically and individually presented those statements to each employee for his signature. The mere fact that the Board, in *Globe Iron Foundry*, paid heed to the information brought to its attention with respect to the showing of interest can in no way be said to privilege an employer to engage in broadside interrogation of its employees based on suspicion or hope that the resultant information will demon-

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[18] There is no merit to petitioner's assertion that the Board here held interrogation for the purpose of checking the authenticity of a union's showing of interest to be *per se* unlawful. As was previously pointed out, the Board found, in the circumstances presented here, that petitioner's interrogation of its employees was unlawful because of its tendency to interfere with their rights of self-organization. While petitioner sought to justify this interrogation by arguing that its purpose was to check the validity of the Union's showing of interest, the Board rejected this as a defense. Rejection of the defense that interrogation is warranted to investigate compliance with the Board's showing of interest requirement is plainly not the same thing as holding interrogation for this purpose to be *per se* unlawful. Petitioner's attack on the *per se* approach thus has no relevance here.

strate an insufficient showing of interest. Cf. *Lindsay Newspapers, Inc.*, 130 NLRB 680, 692.[19]

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[19] Petitioner's contention (Brief, p. 61) that the Board's failure to dismiss the Union's representation petition was erroneous and that this Court should order that petition dismissed does not present an issue cognizable by this Court. A determination made by the Board in a representation proceeding is not a "final order" within the meaning of Section 10(e) or (f) of the Act and is not, therefore, directly reviewable by the Courts of Appeals. The only circumstance in which a Court of Appeals may review Board action taken in a representation proceeding under Section 9(c) is when the Board, acting under Section 10(c), issues an unfair labor practice order based "in whole or in part upon the facts certified" as the result of such Section 9(c) proceedings. That not being the case here, the determination of which petitioner complains is not subject to review by this Court. *A.F. of L.* v. *N.L.R.B.*, 308 U.S. 401, 408-412; *N.L.R.B.* v. *I.B.E.W.*, 308 U.S. 413, 414-415; *N.L.R.B.* v. *Falk*, 308 U.S. 453, 458-459; *Timken-Detroit Axle Co.* v. *N.L.R.B.*, 197 F. 2d 512 (C.A. 6); *Bonwit Teller, Inc.* v. *N.L.R.B.*, 197 F. 2d 640, 642, n. 1 (C.A. 2), cert. den., 345 U.S. 905; *N.L.R.B.* v. *LaSalle Steel Co.*, 178 F. 2d 829, 832, n. 1 (C.A. 7).

Petitioner's additional assertion that the Board's decision goes beyond the scope of the complaint and the issues raised therein (Brief, pp. 13-17) is patently frivolous. The complaint alleged that petitioner's interrogation of its employees had been in violation of their Section 7 rights (R. 5), and the Board so found. Those parts of the Board's decision to which petitioner takes exception, primarily the Board's discussion of its showing of interest requirement, were made necessary by petitioner's assertion that "it was justified in conducting interviews for the purpose of showing that [the Union] did not have a proper showing of interest" (R. 20).

CONCLUSION

For the reasons stated, it is respectfully requested that the petition to review and set aside the Board's order be denied, and that a decree should be entered enforcing the Board's order in full.

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National Labor Relations Board.

March, 1963.

CERTIFICATE

The undersigned certifies that he has examined the provisions of Rules 18 and 19 of this Court, and in his opinion the tendered brief conforms to all requirements.

MARCEL MALLET-PREVOST
Assistant General Counsel
National Labor Relations Board

APPENDIX

The relevant provisions of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Secs. 151, *et seq.*) are as follows:

RIGHTS OF EMPLOYEES

Sec. 7. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in section 8(a)(3).

UNFAIR LABOR PRACTICES

Sec. 8.(a) It shall be an unfair labor practice for an employer—

(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7;

* * * *

REPRESENTATIVES AND ELECTIONS

Sec. 9.(c)(1) Whenever a petition shall have been filed, in accordance with such regulations as may be prescribed by the Board—

(A) by an employee or group of employees or any individual or labor organization acting in their behalf alleging that a substantial number of employees (i) wish to be represented for

collective bargaining and that their employer declines to recognize their representative as the representative defined in section 9(a), or (ii) assert that the individual or labor organization, which has been certified or is being currently recognized by their employer as the bargaining representative, is no longer a representative as defined in section 9(a); or

(B) by an employer, alleging that one or more individuals or labor organizations have presented to him a claim to be recognized as the representative defined in section 9(a);

the Board shall investigate such petition and if it has reasonable cause to believe that a question of representation affecting commerce exists shall provide for an appropriate hearing upon due notice. Such hearing may be conducted by an officer or employee of the regional office, who shall not make any recommendations with respect thereto. If the Board finds upon the record of such hearing that such a question of representation exists, it shall direct an election by secret ballot and shall certify the results thereof.

* * * *

PREVENTION OF UNFAIR LABOR PRACTICES

Sec. 10(a) The Board is empowered, as hereinafter provided, to prevent any person from engaging in any unfair labor practice (listed in section 8) affecting commerce. This power shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law, or otherwise: * * *

(b) Whenever it is charged that any person has engaged in or is engaging in any such unfair labor

practice, the Board, or any agent or agency designated by the Board for such purposes, shall have power to issue and cause to be served upon such person a complaint stating the charges in that respect, and containing a notice of hearing before the Board or a member thereof, or before a designated agent or agency, at a place therein fixed, not less than five days after the serving of said complaint: *Provided*, That no complaint shall issue based upon any unfair labor practice occurring more than six months prior to the filing of the charge with the Board and the service of a copy thereof upon the person against whom such charge is made, unless the person aggrieved thereby was prevented from filing such charge by reason of service in the armed forces, in which event the six-month period shall be computed from the day of his discharge. Any such complaint may be amended by the member, agent, or agency conducting the hearing or the Board in its discretion at any time prior to the issuance of an order based thereon.

(c) * * * If upon the preponderance of the testimony taken the Board shall be of the opinion that any person named in the complaint has engaged in or is engaging in any such unfair labor practice, then the Board shall state its findings of fact and shall issue and cause to be served on such person an order requiring such person to cease and desist from such unfair labor practice, and to take such affirmative action including reinstatement of employees with or without back pay, as will effectuate the policies of this Act: * * *

* * * *

(e) The Board shall have power to petition any court of appeals of the United States, . . . within any circuit . . . wherein the unfair labor practice in

question occurred or wherein such person resides or transacts business, for the enforcement of such order and for appropriate temporary relief or restraining order, and shall file in the court the record in the proceedings, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall cause notice thereof to be served upon such person, and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to grant such temporary relief or restraining order as it deems just and proper, and to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board. No objection that has not been urged before the Board, its member, agent, or agency, shall be considered by the court, unless the failure or neglect to urge such objection shall be excused because of extraordinary circumstances. The findings of the Board with respect to questions of fact if supported by substantial evidence on the record considered as a whole shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the hearing before the Board, its member, agent, or agency, the court may order such additional evidence to be taken before the Board, its member, agent, or agency, and to be made a part of the record. . . . Upon the filing of the record with it, the jurisdiction of the court shall be exclusive and its judgment and decree shall be final, except that the same shall be subject to review by the . . . Supreme Court of the United States upon writ of certiorari or certification as provided in section 1254 of title 28.

(f) Any person aggrieved by a final order of the Board granting or denying in whole or in part of relief sought may obtain a review of such order in any circuit court of appeals of the United States in the circuit wherein the unfair labor practice in question was alleged to have been engaged in or wherein such person resides or transacts business, or in the United States Court of Appeals for the District of Columbia, by filing in such court a written petition praying that the order of the Board be modified or set aside. A copy of such petition shall be forthwith transmitted by the clerk of the court to the Board, and thereupon the aggrieved party shall file in the court the record in the proceeding, certified by the Board, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall proceed in the same manner as in the case of an application by the Board under subsection (e) of this section, and shall have the same jurisdiction to grant to the Board such temporary relief or restraining order as it deems just and proper, and in like manner to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board; the findings of the Board with respect to questions of fact if supported by substantial evidence on the record considered as a whole shall in like manner be conclusive.

* * * *

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No. 18,240

In The

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JANE G. WEST and RALPH E. WEST, Appellants, vs. RUTH SHIZUKO TAN, individually and doing business as BANYAN INN, Appellee.	)

PETITION FOR REHEARING

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INDEX

AUTHORITIES

No. 18,240

IN THE
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JANE G. WEST and RALPH E. WEST,

Appellants,

vs.

RUTH SHIZUKO TAN, individually and doing business as BANYAN INN,

Appellee.

PETITION FOR REHEARING

Appellants hereby petition this Court for rehearing after decision of this Court, dated September 23, 1963. Said decision determined that plaintiff wife was a bare licensee while playing a piano in defendant's restaurant and that she could not, for that reason, recover.

Grounds for Rehearing

Rehearing is sought upon the ground that, while there is substantial evidence to support a conclusion that plaintiff was a licensee, which said evidence is summarized in the decision of this Court, there is equally substantial evidence to support the jury's determination that plaintiff was an invitee. This latter evidence, possibly, was not heretofore brought clearly to the attention of this Court, since the same does not appear in the

said decision.

The Evidence

The evidence supporting the jury's implied finding that plaintiff was an invitee may be summarized as follows:

1. The area involved here was a part of the public dance area, separated therefrom only by a single step.

2. There was no barricade or fence between the admittedly public dance area and the piano played by plaintiff.

3. The piano was so located as to be immediately available to patrons, without being moved or prepared in any way.

4. A chair for the piano was left available.

5. A light was left available.

6. The absence of any sign in the questioned area forbidding entrance thereto was affirmatively shown.

7. The failure of defendant to object to the piano playing, though she was fully aware of the same, was affirmatively shown.

8. The fact that defendant's waitress affirmatively encouraged plaintiff to play the piano was shown.

9. It was shown that this was not a formal type of restaurant; the "rule" was informality, so that plaintiff's piano-playing was quite in keeping with the "nature of the business."

10. Plaintiff's presence in the questioned area did serve defendant's interests: Other guests of defendant listened to, and enjoyed, plaintiff's piano playing. Further, the very reason that plaintiff went to defendat's restaurant rather than to another restaurant was because there was a piano available there.

The Law

It is respectfully submitted that the foregoing evidence clearly brings plaintiff within the definition of an invitee, rather than a licensee, as defined by the very authorities cited in this Court's decision (Restatement of Torts and Prosser on Torts)

Prosser states at page 445, et seq., that a licensee is one who enters with consent

> "* * * and nothing more. Such a person is not a trespasser, but he comes for his own purposes rather than for any purpose or interest of the landholder."
>
> "* * * the duty of affirmative care in making the premises safe is imposed upon the man in possession as the price he must pay for the economic benefit he derives, or expects to derive from the presence of the visitor; and that when no such benefit is to be found, he is under no such duty. On this basis the 'business' on which the visitor comes must be one of at least potential pecuniary profit to the possessor." (page 453; emphasis added)
>
> "* * * The special obligation toward invitees exists only while the visitor is upon the part of the premises which the occupier has thrown open to him for the purpose which makes him an invitee. This 'area of invitation' will of course vary with the circumstances of the case. * * * [I]t extends to all parts of the premises to which the purpose may reasonably be expected to take him, and to those which are so arranged as to lead him reasonably to think that they are open to him. * * * If the customer is invited or encouraged to go to an unusual part of the premises, such as behind a counter or into a storeroom, for the purpose which has brought him, he remains an invitee; but if he goes without such encouragement and solely on his own initiative, he is only a licensee * * * ." (page 458; emphasis added)

Simiarly, the Restatement of Torts, Sec. 343, comment (b), cited by this Court, states:

> "Under the rule stated in this section a possessor of land is subject to liability to another as a business visitor only for such bodily harm as he sustains while upon a part of the land upon which the possessor gives the other reason to believe that his presence is permitted or desired because

of its connection with the business or affairs of the possessor and which as such is held open to the other as a business visitor. In determining the area included in a business invitation, the nature of the business to be transacted is of great importance. * * * Where it is customary that customers or patrons shall be free to go to certain parts of the premises, the customer or patron is a business visitor thereon unless the possessor exercises reasonable care to apprise the customer or patron that the area of invitation is more narrowly restricted." (Emphasis added)

Conclusion

It is respectfully submitted that even though there is substantial evidence from which the Court might find that plaintiff was a licensee in the questioned area, nevertheless there is abundant evidence to support the implied determination of the jury to the contrary.

Prior decisions of this Court, heretofore cited, along with a host of decisions from other jurisdictions heretofore cited, have uniformly held that the question of whether a plaintiff is an invitee or a licensee is a question of fact, to be determined by the jury.

Here the jury has found that plaintiff was an invitee. There is substantial evidence to support that determination. Under such circumstances, we submit the Court is bound by such determination unless the purpose of the jury system be held to be totally meaningless.

Respectfully submitted,

SULLIVAN, ROCHE, JOHNSON & FARRAHER
AXEL J. ORNELLES

By _____
Attorneys for Appellants

C E R T I F I C A T E

Pursuant to Rule 23 of the Rules of this Court, the undersigned hereby certifies that he is one of the attorneys for appellant herein.

That the foregoing Petition for Rehearing is well founded, and is not interposed for delay.

DATED: October 14, 1963.

Gerald J. O'Connor

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL, *et al.*,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF OF APPELLANT DAVID FARRELL.

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TOPICAL INDEX

INDEX TO APPENDICES

TABLE OF AUTHORITIES CITED

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL, *et al.*,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF OF APPELLANT DAVID FARRELL.

Jurisdiction of Trial and Appellate Courts.

From his conviction by a jury on an indictment[1] charging violations of the fraud provisions of The Security Act of 1933,[2] the Mail Fraud Statute[3] and for conspiring to violate these statutes,[4] and from the Judgment thereon [R. 4390-4392], David Farrell respectfully appeals.

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[1]*United States of America v. David Farrell, et al.,* U. S. District Court, Southern District of California, Central Division, No. 30341-CD [Clk. Tr. 119 *et seq.*] filed December 20, 1961 and plea of "not guilty" made to all 34 counts [R. P-10]. Jury's verdict April 16, 1962 [Clk. Tr. 505-508] and judgment filed May 14, 1962 [Clk. Tr. 558-559].

[2]15 U. S. C. A. §77q(a)(1). Counts One, Two, Four through Seventeen. Count Three was dismissed [R. 3046].

[3]18 U. S. C. A. §1341. Counts Eighteen through Thirty-Two. Count Thirty-Three was dismissed [R. 3046].

[4]18 U. S. C. A. §371. Count Thirty-four.

The District Court had jurisdiction of the trial[5] as does this Court of this appeal.[6]

Statement of the Case.

After approximately six weeks of trial, some 4,400 pages of Reporter's Transcript of trial testimony and the introduction of thousands of exhibits, with much repetition, David Farrell and his brother O. J. Farrell[7] were found guilty, in effect, of having devised a scheme and conspired to defraud customers of Los Angeles Trust Deed & Mortgage Exchange [LATD] and/or its parent corporation, Trust Deed & Mortgage Exchange and affiliate companies.[8] That the United States mail was involved was admitted.

As to Counts One through Seventeen, the jury also found there was a "security" involved in what was being offered and/or sold to the public by the defendants. What, if at all, that "security" consisted of, was in serious dispute [R. 4311-4313; see also Vol. 22, pp. 3701-3705, N. B. Vol. 23 has duplicate pagination]. The Government's contention being the trust deeds sold were not only "investment contract"[9] but also "notes" or "evidences of indebtedness" under the provisions of

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[5]15 U. S. C. A. §77v(a) and §77t(b) as to Counts One, Two, Four through Seventeen; 18 U. S. C. A. §3231 and Fed. Rules Cr. Proc. Rule 18, U. S. C. A. as to the remaining counts.

[6]28 U. S. C. A. §1291.

[7]A co-appellant herein by separate brief.

[8]Trust Deed & Mortgage Exchange (TD&ME); Trust Deed & Mortgage Markets (TD&MM); Colorado Trust Deed & Mortgage Markets (CTD&MM).

[9]As the 2nd trust deed sold during the period were held to be in the civil action preceding this criminal case. See *Los Angeles Deed & Mortgage Exchange v. Security Exchange Commission,* 9th Cir. 1960, 285 F. 2d 162, 172.

The Securities Act of 1933.[10] Appellant seasonably objected [R. 4311-4312] to the Court's charge in reference thereto [R. 4267-4268] and assigns said charge as an error in this appeal.[11]

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[10]15 U. S. C. A. §77b(1).

[11]The Court charged [R. 4266, 4267 and 4268] as follows:

". . . Counts One and Two and Counts Four through Seventeen of the indictment each alleges that the defendants devised and executed a scheme to defraud in the sale of 'securities' as defined in Section 2(1) of the Securities Act of 1933, namely, 'investment contracts, promissory notes, evidence of indebtedness and receipts for and guarantees of such securities.' . . .

* * *

". . . Section 2(1) of the Act defines the term 'security' to include 'any note, evidence of indebtedness, investment contract, receipt for or guarantee' of any such security.

* * *

"Going back to the charges under the Securities Act, the requirement that the government establish that the Secured 10% Earnings offered by the defendants involved the sale of securities will be established if you find that the trust deed notes or trust deeds are 'notes' or 'evidence of indebtedness,' as defined by the Act."

Appellant objected to this charge [R. 4311-4312] as follows:

"Mr. Dunn: With reference to the Court's instructions as to the term 'security,' specifically since the court has included notes, I would like to call attention to the fact that notes are not within the accepted application of the statute. Although I know that the terms are that broad, they have not been applied that broadly. They have been confined to an investment contract, as I had urged the court at the beginning. I think that we might have avoided that trouble—

The Court: That is true. But the government would not take that position, and since the government has taken this position, I think, Mr. Dunn, since the definition is as it is, I am going to follow it.

Mr. Dunn: I have my exception, then, your Honor, that without referring to the exemptions which might apply, this is an erroneous instruction."

Appellant also asked that the Court instruct that the only type of security involved was that known as an "investment contract" [Clk. Tr. 487]:

"In determining whether there was a violation of the Securities Act you must first find that the Defendants, or any one of them, engaged in the offer or sale of securities.

The criminal action had been preceded by a civil action filed and prosecuted in the Federal Courts by the Security and Exchange Commission against Appellant David Farrell and others. A full recitation of the allegations, issues, opinions and events of that action is not required for the purposes of this brief, but are available for review in the published reports.[12] It is important to note, however, that almost without exception all of the acts or omissions charged against Appellant in the present indictment fell within the time period when the SEC was militantly and relentlessly demanding ultimate and terminal legal sanctions against LATD, TD&ME, David Farrell and others. This was from March, 1958 when the first SEC complaint was filed until June 8, 1960. Further, the anti-fraud structure of the civil action and the testimony and exhibits offered by the SEC in that action to support its allegations therein were qualitatively, but by no means quantitatively, similar to the anti-fraud structure and

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There are a number of different types of securities, however, you will only be concerned with the type known as an investment contract.

If you find that the transactions charged were not investment contracts, then you must find the Defendants not guilty of violations of the Securities Act in Counts One to Seventeen, inclusive."

[12]See *Los Angeles Trust Deed & Mortgage Exchange v. SEC,* 9th Cir. 1959, 264 F. 2d 199, where this court reversed the District Court's issuance of a preliminary injunction and the appointment of a temporary receiver. After a full trial, the District Court rendered its decision, findings of fact and conclusions of law in May, 1960. See *SEC v. Los Angeles Trust Deed & Mortgage Exchange, et al.,* U. S. D. C., S. D. Calif., CD, 1960, 186 Fed. Supp. 830. This judgment, except as to the liquidation powers of the receiver, was affirmed in an opinion of this Court November 23, 1960 set forth in 285 F. 2d 162. Rehearing denied January 10, 1961; cert. denied May 8, 1961, 366 U. S. 919, 81 S. Ct. 1095, 6 L. Ed. 2d 241.

evidentiary pattern of the instant criminal case. Despite this obvious similarity, the Government sought in the criminal case to introduce in evidence the civil case[13] and specifically the pleadings, the Judgment of May 20, 1960 and the prefatory remarks of the trial Judge of May 4, 1960,[14] The Appellant at all times objected [R. 270, 2870-2874] and the Court reserved ruling and the matter was further discussed between Court and counsel. Finally, again over the objection of the defendants [R. 3026, 3029-3031], the Court read to the jury its condensation of the prior civil action and its outcome. The Court charged the jury that the evidence was of restricted use.[15] This action by the Court is assigned as error.

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[13]And did so in the opening argument [R. 32]:

"You will hear later in this regard how there was litigation going on during this time with the Securities and Exchange Commission charging (1) You people are dealing in securities, (2) You are defrauding people, and also you are insolvent."

[14]A certified copy of the original complaint, Exhibit 5201 for identification; a certified copy of the amended complaint, Exhibit 5200 for identification; copy of the answer Exhibit 5200-A for identification; and a copy of the Honorable Thurmond Clarke's May 4, 1960 indication of ruling, Exhibit 1950-A for identification [R. 2869-2870]. Exhibit 1950 was offered and received provisionally [R. 269]. It was Judge Clarke's judgment of May 20, 1960 granting the injunction and appointing the receiver.

[15]"The Court: Members of the jury, in lieu of the acceptance in evidence of Exhibits 1950, 5200, 5201 and 1950-A, I will give you a summary of some of the facts in such exhibits which I deem of possible relevance or materiality for your consideration.

"On March 24, 1958, the Securities & Exchange Commission filed a complaint against Los Angeles Trust Deed and Mortgage Exchange, Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Markets, David Farrell, Oliver J. Farrell, Roy A. Bonner, and Thomas Wolfe, Jr., charging the defendants with violation of certain sections of the Securities Exchange Act, including charges that defendants were engaged in transactions, practices and a course of business which operated and would

The prior civil action cast its long shadow even deeper into the criminal action. It is without dispute that from May 4, 1960 and up to June 8, 1960, the day the Federal Receiver took over LATD, TD&ME and other affiliated companies, the Appellant continued in business on advice of counsel expecting to appeal the decision. There was during that period an avalanche of requests by former purchasers of trust deeds from LATD, that LATD either sell for them or buy from them their trust deeds. There is no dispute that from approximately the first week in May, 1960 until June 7, 1960, close to $3,000,000.00 worth of such liquidation requests or sell orders had been processed by LATD and that approximately 800 more sell orders amounting to approximately $3,630,000.00 remained unprocessed [R. 2798]. The Government on the subject of liquidation requests and dollar volume thereof

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operate as a fraud and deceit upon purchasers of such alleged securities.

"On October 8th, 1958, the Commission filed an Amended and supplemental Complaint charging the corporate defendants with misappropriation of funds entrusted to them by investors under the Secured 10% Earnings Program, and further charged that said corporate defendants were insolvent and unable to meet their current obligations. The Amended Complaint included as a party defendant Stanley C. Marks.

"The charges in both the original and the Amended and Supplemental Complaint were denied by the defendants.

"On May 20, 1960, a judgment was entered in said proceedings permanently enjoining the defendants from engaging in the acts as charged. The effect, however, of this injunction was stayed—that is, put off—by an appeal.

"Pursuant to the judgment the Receiver took charge of the assets and business of the corporate defendants on June 8, 1960.

"Now, neither the charges made in the pleadings in such case nor said judgment are to be considered by you as evidence of the truth of such charges. The above statement of facts is given to you solely in connection with your consideration of the charges made in Paragraph 11, Count One, of the indictment." [R. 3026-3028.]

had testify Mr. Leroy H. Cole an accountant hired by the Federal Receiver. Mr. Cole was allowed to testify to the dollar volume and the Government, over objection, introduced a summary of said liquidation requests [R. 2800-2801: Ex. 6002]. Mr. Cole testified the underlying documents in support of Exhibit 6002 were in the courtroom [R. 2798]. The Government at first asserting it had no intention of introducing the so-called underlying documents (consisting of two baskets of papers) had them marked for identification as Exhibit 6003 [R. 1664, 2789], but suddenly offered said exhibit in evidence in addition to the summary. Over the objection of the defendants[16] the exhibit was admitted. In connection therewith the Court itself attempted to lay a foundation for said exhibit.[17] The exhibit contained far more than just liquidation requests for there were also writings, letters and at least in one instance, apparently, a newspaper clipping quoting the Hon. Thurmond Clarke's remarks of May 4,

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[16][R. 2795, 96, 99]:

"Mr. Jacobs: We would object to them, if the Court please, on the ground that they are incompetent, irrelevant and immaterial and no proper foundation.

* * *

"Mr. Jacobs: Your honor, we object to it on the grounds that there is no proper foundation. Especially, in looking at 6002, and the dates, apparently, that are put in here, they are all late in June, or June 6th and 7th, and certainly would not be admissible in that regard unless there was a foundation as to the time the requests were received."

[17][R. 2799]:

"The Court: Were these requests part of the books of the company when you went to make the audit at the time you assisted in taking over? Were they in the possession of the company at that time?

The Witness: They were in the possession of the company.

The Court: The objection is overruled, to 6003."

1960 in connection with his anticipated ruling in the civil action. A copy of Judge Clarke's actual May 4th remarks had theretofore been offered by the Government as Exhibit 1950A and had been rejected [R. 2869-2870] (the statement of May 4, 1960 appears in 186 F. Supp. 830). As shall be more thoroughly set forth in argument, these writings were of the most objectionable nature—heresay, accusatory, violent and inflammatory. No foundation whatsoever was laid for these extra-judicial assertions and the admission of said exhibit is assigned as error. Extensive argument on this subject was had in reference to a motion for new trial. The motion was denied [R. 4348-4350, 4359-4361].

In light of the fact that the Receiver had taken possession of TD&ME and LATD and the affiliate companies on June 8, 1960, there soon developed in the criminal trial a problem concerning the admissibility of evidence of events occuring after June 7, 1960. The defendants' position in substance was that they could not and should not be held responsible for such events nor should evidence be admitted referring to such events since the defendants were thereafter powerless to act or to control the affairs of the companies.[18] Discussions between Court and counsel soon developed concerning the admissibility of evidence as to events occurring subsequent to June 7, 1960.[19] The Court's

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[18]A forecast of this problem was made by Appellant's attorney in his opening argument [R. 100-101] and it next came to issue [R. 1048] in a discussion concerning the admission of a post-receiver notice of default of a deed of trust owned by a customer witness.

[19][R. 1088]:

"Mr. Dunn: It was my understanding from that that we would not go into matters after June 8, 1960. However,

rule [R. 1293] on this problem was employed fairly by the Court in all save one situation—the most vital of all—where customer-witnesses were asked if they

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they were gone into. It got into the record as it stood, and we would like to reserve our rights and make any proper motion to strike. But at this time I would like to also move that the Government be instructed not to attempt to present matters regarding defaults and what occurred to the property after June 8, 1960, when the receiver was in control of Los Angeles Trust Deed & Mortgage Exchange.

That would be a general motion, because I assume—

* * *

"The Court: . . .

Now, I would like to just hear from the Government as to how you believe that that can have any relevancy or materiality whatsoever. After all, if there was an insolvency on the date of the receivership, that is it. If something else was caused or happened after that time, what difference does it make?

Mr. Medvene: If the court please, that wouldn't have anything to do with the insolvency. What that testimony would have to do with, your Honor, is whether in truth or in fact the trust deeds were actually prime, trouble-free, well-screened trust deeds. And we think the evidence that the trust deeds were delinquent—not because of any condition necessarily of LATD, but were delinquent because of the nature or type of property that they were put on, and that this had relevance in relationship to the program as it was presented to the potential investor.

The Court: The ultimate question, though, would be the nature of the trust deeds as of the date of receivership rather than what happened later, Mr. Medvene, because I think we all have to recognize that the appointment of a receiver is necessarily going to affect the value of whatever the security might be, if they had anything to do with it. *So I really think that our basic problem is what were the values as of the date of the receivership and before that time.*" (Emphasis added.)

* * *

[Continuing R. 1092]

"The Court: I am still going to hold my reservation of ruling on it. I think Mr. Medvene, you may be getting into dangerous territory.

* * *

The Court: I will still reserve my ruling and let us keep away from that during the course of the day here,

ever got their money back. The Court not only allowed such questioning, but suggested the propriety thereof as a means of saving time.[20] On one occasion the Court

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and I will think about it over the week-end and we will have a ruling on Monday.

* * *

[which the Court did R. 1293]:

"The Court: All right.

With reference to the general line of testimony that is before and after the receivership, gentlemen, I don't believe at this time, at least, that I can adopt a general rule on that. I believe that under some circumstances such evidence is admissible, such as *United States vs. Tellier,* 255 F. 2d 440, 448, 449. In other cases it has been held inadmissible. And the reason for the distinction between the two becomes obvious to anyone who would read the cases.

So for that reason I feel that I cannot adopt a general rule on it, although to say this: *That generally speaking what happened after that time, except insofar as it might be declarations against interest, or something such as that, why, it would seem to be inadmissible, or that it wouldn't have any particular relevancy or materiality . . .*" (Emphasis added.)

[20] [R. 1479-1481]:

". . ., it would seem to me that a great deal of time could be saved by just asking the witnesses direct questions as to the amount of money they put in and under what circumstances they put it in *and whether they ever got it out,* and the type of trust deeds . . . (Emphasis added.)

* * *

[R. 1516]:

"The Court: . . . If you want to ask him if he got the money back. . . .

Q. By Mr. Schulman: Did you receive your investment back from the Los Angeles Trust Deed & Mortgage Exchange, sir?

Mr. Jacobs: I object to that for the reason, your Honor, it would be a question of whether he received his funds as represented prior to June 7, 1960.

The Court: This might be some evidence of the condition of the company at the time. The objection is overruled.

Did you receive your money back? Answer the question Yes or No. That is the question. As I say, I think you have already answered it, but answer it again for counsel.

foreclosed any cross-examination of a customer-witness who had testified on direct to losses to show he actually had not or need not have lost at all, or that the loss suffered was due to events occurring after June 7, 1960.[21] On only one occasion on this subject did the

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The Witness: No, I only received a small part of it back.

Q. By Mr. Schulman: Did you receive a full-term 10% return on your earnings. sir? A. While it was invested in the company up to this date that you mentioned, yes, I did. Since then, no."

[21] [R. 1517]:

"By Mr. Jacobs: Q. You made a remark, sir, that you had sustained certain losses. The fact is that any loss you sustained, or I assume you have sustained, was subsequent to the time that the receiver took over the Mortgage Company; isn't that correct?

Mr. Schulman: An objection, your Honor. This is the same conclusion that I believe Mr. Jacobs objected to before.

The Court: I will sustain the objection."

This ruling was discussed later [R. 1540-42] and the Court said:

"The Court: . . .

"What I am attempting to hold it to here is that I believe the Government has a right to show that these people did not get all their money back, and that the particular witness has a right to express his opinion, since he is the owner of the property, after looking back on it as to the value and as to whether it was valueless or whether it was not. That is the position of the court at the present time, and I am trying to hold it to that June 7th date.

* * *

I think we all recognize—certainly I do—that even though it might be a prime second trust deed, the fact that insolvency occurred of some kind and that that paper was still in the possession of the company might affect the market value of that second trust deed.

* * *

The Court: I recognize that, but I will stay with my original cutoff date there, the date of the receivership. It is the values as of that date, and although information might have been obtained later, it would be the values as of that date. I will stay with those rulings."

Court actually limit inquiry so as to effectively comply with its own rule that events occurring after June 7th were inadmissible.[22] The Court gave a charge to the jury which may be asserted as having cured any error on this subject but as will be pointed out in argument did not do so.[23]

Thus, throughout the trial, the Government effectively wove into the framework of the evidence and the minds of the jurors, testimony of customers to the effect that as of the time they were then testifying (*i.e.* March or April, 1962), they had not as yet received back their money.[24]

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[22][R. 1847]:

"The Court: No, counsel. You may ask *if he tried* to get it back and *when,* and then you will keep within the rule on it." (Emphasis added.)

[23][R. 4304]:

"The evidence in this case of a bankruptcy or a receivership of LATD&ME is not to be considered by you as evidence of the guilt of any one or more of the defendants or evidence on any other issue in the case.

You shall disregard any evidence or testimony of Los Angeles Trust Deed & Mortgage Exchange and affiliated companies to the effect that a loss was suffered after June 7, 1960. The defendants are not charged with responsibility for acts occurring after that date."

[24]EPPLEY [R. 775]:

"Q. *Did* you *ever* receive that money, Mrs. Eppley? (Emphasis added.) A. No I *haven't.*" (Emphasis added.)

MARTENS [R. 1017]:

"Q. *Did you ever get back* your money from Los Angeles Trust Deed & Mortgage Exchange? (Emphasis added.) A. No, sir; I didn't; not one dime."

BROOME [R. 1126]:

"Q. *Have you ever received* any or all of the money which you paid into or deposited with Los Angeles Trust Deed & Mortgage Exchange back from the company, sir? (Emphasis added.) A. Any or all?

Q. Any part or all of the monies which you invested with the company, *did* you ever receive it back? (Emphasis

Note: This Appellant does not assert insufficiency of the evidence simply in recognition of the limited role a reviewing Court has in such a situation. While it is true it cannot be said as a matter of law there was no evidence nor inference drawable therefrom sup-

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added.) A. I never received a cent back from the company . . ."

HENNO [R. 1147]:

"Q. Did you ever receive all or any portion of your $1,000 deposit back from L. A. Trust Deed? A. No.

Q. Did you ever receive any part of any earnings back from L. A. Trust Deed? A. No."

FREEDMAN [R. 1499-1500]:

"Q. By Mr. Schulman: . . . 'we have charged your account $3,470.86,' did you ever receive that $3,470.86 back from this investment? A. No. I lost it.

* * *

[R. 1506]:

"Q. Did you ever receive your money out of this trust deed investment, sir? A. No. I lost it.

* * *

[R. 1508]:

"Q. Sir, the cash to you on this was $1,582.52. Did you receive the full amount of your investment back? A. No. I suffered a partial loss.

* * *

[R. 1511]:

"Q. The cash to you on this of or, for $601.35, did you ever get back that investment or any part of it, sir?

A. Not *as yet.* (Emphasis added.)

* * *

[R. 1516]:

"The Court: . . .

If you want to ask him if he got the money back—I think you have already asked him.

Q. By Mr. Schulman: Did you receive your investment back from Los Angeles Trust Deed & Mortgage Exchange, sir?

Mr. Jacobs: I object to that for the reason, your Honor, it would be a question of whether he received his funds as represented prior to June 7, 1960.

The Court: This might be some evidence of the condition of the company at the time. The objection is overruled.

The Court: Did you receive your money back? Answer the question Yes or No. That is the question. As I say,

porting the verdict, the evidence was weak and attenuated on the one real issue involved in the whole long trial—intent. To make a judgment of a person's intent so intimately involves a trier-of-fact's likes or dislikes,

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I think you have already answered it. But answer it again for counsel.

The Witness: No, I only received a small part of it back.

Q. By Mr. Schulman: Did you receive a full-term 10% return on your earnings, sir? A. While it was invested in the company up to this date that you mentioned, yes, I did. Since then no."

HLAVKA [R. 1802]:

"Q. . . . Referring to the $1,000 on that receipt that you are holding in your hand, and any other monies that were indicated on the condensed summaries which you received monthly, have you ever received any of that back? A. No, I didn't. . . ."

LEES [R. 1831]:

"Q. How much of that ten thousand three hundred thirty-six odd dollar figure have you ever received back from Los Angeles Trust Deed & Mortgage? A. Nothing."

YOUNGS [R. 1840]:

"Q. Have you ever gotten a cent back, Mr. Youngs? A. No, sir."

CAMPBELL [R. 1856]:

"Q. By Mr. Schulman: Relating to this amount on this May 31st, did you ever receive that amount of money or any other amount of money back from L. A. Trust Deed? A. Not a cent."

SCHANZ [R. 1877 *et seq.*]:

"Q. Mr. Schanz, did you ever receive a penny back on this trust deed?

Mr. Jacobs: I object to that, if the court please. There is no foundation laid for it from a time standpoint or whether any demand was made.

The Court: Ask him the question if he ever asked for any of it back.

The Witness: No, I never got any money back.

Q. By Mr. Medvene: Have you ever gotten anything back on it? A. No I haven't.

Mr. Jacobs: I don't think the question that was referred to, your Honor, that we were talking about was asked him. I didn't hear it.

The Court: Did he ever ask for anything back?

Mr. Medvene: *He never asked prior to the receiver.*

any error which raises the wrath of the jury and thus destroys its objectivity must be considered egregious, prejudicial and reversible. Appellant urges this Court to review the whole record not unmindful of its great

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The Court: Would you ask him the question if he ever asked for it back.

Q. By Mr. Medvene: *Did* you *ever* ask for anything back prior to the receiver. A. No, I never did.

Q. *Have* you *ever* gotten anything back on this *now*? A. No."

LIST [R. 1905]:

"Q. *Have* you *received* all of that money back *yet,* sir? A. I received papers—

Mr. Jacobs: Just a moment.

The Court: Did you receive the money back is the question.

The Witness: No, I didn't."

DAVIS [R. 1967-68]:

"Q. *Did* you *ever* get a cent out of this? A. No."

COOK [R. 1980-81]:

"Q. *Have* you *ever* gotten a cent back from this investment? A. None whatsoever.

* * *

Q. *Have* you *ever* gotten a cent back on this property? A. Nothing at all.

* * *

Q. By Mr. Medvene: *Did* you *ever* get anything back on this? A. Nothing at all."

WEGNER [R. 1996-97]:

"Q. *Have* you *ever* received a cent back on this investment? A. No sir."

PEARSON [R. 2023]:

"Q. *Did* you *ever* get back your $28,000, sir, from the company? A. No, sir."

LIBBY [R. 2182]:

"Q. I am referring now to after you made your last deposit, the last $1,547. A. Yes.

Q. Did you receive any of your principal back from the company? A. No."

LEHMBERG [R. 2280]:

"Q. *Did* you *ever* get that money back from the company? A. None of it."

BILLINGSLEY [R. 2762]:

"Q. *Have* you *ever* received any of your principal back from the company? A. I have not."

size and seeming complexity, because it is felt by doing so the prejudicial impact of the errors will become obvious.

Actually the trial of this case was remarkable in several ways, the most noteworthy of such is the astounding fact that there really is not much conflict as to the evidence. The operations and activities of TD&ME, LATD and Appellant from January, 1958 to June 8, 1960 and what was or was not said and done were really basically agreed to. An agreement, however, which carries with it no concession that a scheme or conspiracy to defraud ever actually existed. The few areas of dispute and how, if at all, these areas were resolved by the jury is not really opened to review.

Thus there is no question Appellant was the founder, president and guiding hand of the activities of TD&ME and LATD etc., and that he took a significant part in controlling every phase of the business and in the presentation of its image, product and services to the public. The brochures and their evolution during the 13-months until the green "export" copy [Ex. 1668] was sent out and after which little or no changes were made is without dispute.[25]

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[25]There was a glut of documentation in this case and there were brochures in evidence in abundance. It is suggested that a good working set of brochures adequate to the needs of the reviewer on this appeal would constitute the following: White Brochure (Dec. '58—Mar. '58) Exhibit 1666 and DF DO; Black Brochure (July-Oct. '58), Exhibit 844; Green Brochure (Feb.-July '59) Exhibit 1668, 1669; Blue Brochure (July '59 —May '60) Exhibit 1670, 1674.

No dispute existed as to wording of monthly Topics and condensed summaries, letters of welcome to new customers, sale confirmations, Appellant's joint venture and trust agreements with subdividers, appraisal reports and news, radio and TV commercials; nor is there any dispute that such documents were sent out, existed, were used and entered into.

There is no dispute that virtually every act complained of was done during the very time when the Securities and Exchange Commission was undertaking its lawsuit with the express aim of liquidating the Appellant's business. It is without dispute that a Receiver took over June 8, 1960 pursuant to the Court's order of 18 days previous. Nor is there any dispute that the Appellant continued in business during that period of time and were advised by attorneys to do so.

Further recital of evidence agreed upon would seem unnecessary and merely re-emphasizes the fact that the only issue for determination was with what intent Appellant acted. The errors herein assigned, considering all of the circumstances which attended the trial of this matter, constituted prejudicial error and had they not occurred the jury would have acquitted.

Assignment of Errors.

I.

The Court erred in its instruction on the issue of security under The Security Act of 1933 on Counts One, Two, Four through Seventeen.

II.

The Court erred in allowing introduction of any evidence of the existence of the prior civil action or the issues involved therein and its determination. There was also error in the phrasing of the Court summary and in the Court's failing to instruct at that time the difference between the burdens of proof in the two actions.

III.

The Court erred in allowing any testimony of losses by customer witnesses in that such evidence was (a) immaterial and irrelevant to the crimes alleged and (b) violative of the Court's own ruling in reference to events occurring after June 7, 1960.

IV.

The Court erred in admitting Exhibit 6003 in evidence.

ARGUMENT.

I.

The Court Erred in Its Instruction on the Issue of Security Under the Security Act of 1933 on Counts One, Two, Four Through Seventeen.

In reference to Security Counts, the Court instructed the jury that in order to sustain all or any one of these counts under The Securities Act it was essential that the jury find not only that the defendants devised and engaged in a scheme to defraud by use of the mails, as alleged in the indictment but also that the scheme to defraud involved the sale of securities as defined by the statute and alleged in the indictment [R. 4267].

The Court then instructed that Section 2 (1) of the Act defines the term "security" to include any note, evidence of indebtedness, investment contract, receipt for or guarantee of any such security [R. 4267, lines 13-16].

After stating the contentions of the respective parties as to whether or not the various instruments offered, sold and issued in connection with the enterprise constituted securities within the confines of the definition, the Court instructed as follows [R. 4268]:

> "Going back to the charges of The Securities Act, the requirement that the Government establish that the Secured 10% Earnings offered by the defendants involved the sale of securities will be established if you find that the trust deed notes or trust deeds are 'notes' or 'evidence of indebtedness' as defined by the Act.
>
> "Regardless of whether or not you find the trust deed notes or trust deeds are 'notes' or 'evidence of

> indebtedness' within the applicable statute, you may find the instrument should be classified as 'investment contracts' and therefore securities within the applicable statutes.
>
> "The term 'investment contract' is not defined in the Act. There are, however, certain guide lines for you to follow in determining, . . ."

The Court set out what is considered to be those guide lines in determining whether the instruments should be classified as "investment contracts" [R. 4268-4271] and added [R. 4272]:

> "You need only find that the instruments here in question constituted securities under any one of the several definitions I have given you and not all of them or more than one of them."

The Appellant's requested instruction and exceptions to the actual instruction are set out in footnote 11, *supra.*

While discussing with the Court the proposed instructions on this point, counsel for Appellant made it abundantly clear that defendants contended that "trust deed notes" were not the "notes" embraced by the definition of a security; that the activity as a whole, the procedure in offering certain services over and above the mere sale of a trust deed, might warrant an instruction on an "investment contract" but that the trust deed notes, in and of themselves, without the surrounding activity, would not constitute securities [R. 3701-3703].

During the same discussion the Government stated its position that even without the indicia of an invest-

ment contract it would be possible to have a note or other evidence of indebtedness which would be a security [R. 3703-3704].

While noting that the Government was going out on a limb in this regard the Court stated that it would simply follow the definition set forth in the Act [R. 3704-3705].

Appellant contends the instruction that the sale of a "security" would be established if the jury should find that the trust deed notes or trust deeds were "notes" or "evidence of indebtedness" as defined by the Act was erroneous in two respects:

First: The trust deed notes or trust deeds, in and of themselves, were not, as a matter of law, "notes" or "evidence of indebtedness" within the meaning of the Act;

Second: Neither "notes" nor "evidence of indebtedness" are defined by the Act and the Court gave the jury no definition or other guide by which to determine whether the trust deed notes or trust deeds were such "notes" or "evidence of indebtedness" as to make them securities within the meaning of the Act.

Basically, Appellant's contention here is, as it was in the trial court, that the only charge should have been with regard to the type security known as an "investment contract"; that the alternative given, wherein the jury could find the trust deed notes or trust deeds to be securities without the indicia of an "investment contract" was not only confusing and misleading but also an erroneous statement of law.

Those common law characteristics of a promissory note, which might render it a "note" within the statutory definition of a "security", have been destroyed in California by various Legislative enactments with reference to purchase money deeds of trust. Under the successive amendments to Section 580(a), 580(b), 580(d) and Section 726 of the Code of Civil Procedure of the State of California, the maker of a purchase money deed of trust has no personal liability or obligation of any sort. The holder of the trust deed has no remedy or recourse against the maker. The trust deed becomes not an evidence of indebtedness but merely evidence of a charge or lien against the land. Where there is no debt as such, there can be no evidence of indebtedness. The cases of *Brown v. Jensen*, 41 Cal. 2d 193; *People v. Davenport,* 13 Cal. 2d 681, and *Nicholl v. Ipsen,* 130 Cal. App. 2d 452, support this interpretation of purchase money deeds of trusts in California. It is recognized that the decisions of State Courts would not be controlling with respect to the interpretation of a Federal statute. (*L.A. Trust Deed & Mortgage Exchange v. SEC,* 264 F. 2d 199, 211). However, it is submitted that the Federal Courts are bound by the decisions of the highest Court of this State defining rights and liabilities under California law arising from a California contract or statute. If the California law declares that a promissory note, given in a purchase money transaction, should have none of the common law characteristics of a promissory note, the Federal Courts should not decree that it is still the common law "note" presumably intended by Congress when it classified a "note" as a "security".

Many of the trust deeds finally evolved had no separate note at all [R. 2529-2530: Ex. 407 at R. 2292]. It would be absurd to classify a document as a security merely because one permissible form was used in lieu of another when, irrespective of whether a note does or does not exist with the trust deed, it has the identical legal function, force and effect and is similar in all respects.

The same issue was before this Court in *L.A. Trust Deed & Mortgage Exchange v. SEC,* 264 F. 2d 199, and this Court specifically stated that it was not reaching the question as to the character of that which was sold. However, for the edification of the trial court, certain guide lines were set forth as follows (*ibid.,* p. 212):

> "We suggest that a proper determination of this case requires a factual finding, in the Court below, as to whether there was an investment 'in a common enterprise' and whether the purchaser 'is led to expect profits solely from the efforts of the promoter or a third party.' [*Securities and Exchange Commission v. W. J. Howey Co.,* 1946, 328 U.S. 293, 298-299, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244] There must also be a consideration of the various other elements which cause or bar the recognition of a document, plan, course of dealing or program, as a security — all factors leading to an ultimate conclusion as to whether or not that which is here sold is subject to the Act."

Such a mandate to the Court below, we submit, would not have been given if this Court had considered the second trust deeds "notes" or "evidence of indebtedness" within the meaning of the Act.

Upon the conclusion of the trial the matter again came before this Court in *L.A. Trust Deed & Mortgage Exchange v. SEC,* 285 F. 2d 162. The first question raised was whether that which was sold was a security within the Act. The SEC contended that the sale constituted more than a simple sale of second trust deeds — an interest in real property; that what was really involved was an investment contract (p. 166). The Court cited, discussed and relied upon two Supreme Court cases to guide it in solving the problems (*SEC v. C. M. Joiner Leasing Corp.,* 320 U. S. 344; *SEC v. W. J. Howey Co.,* 328 U. S. 293). With these guides in mind, and upon a review of the evidence, the Court held that the Appellants — by their representations to the public, created and constituted the second trust deed notes securities subject to the Act (pp. 171-172). The Court concluded on this point as follows:

> "The terms of the offer, the plan of distribution, the economic inducements held out to the prospects, the results dependent on one other than the purchaser, the common enterprise, *all combine herein to make the second trust deed notes 'securities' as* that term has been defined by the Supreme Court." (emphasis added).

Implicit in this holding is recognition that the second trust deed notes, in and of themselves, were not securities. It was the overall activity in connection with the marketing of such instruments which combined to bring them within the reach of the Act. It was the presence of the indicia laid down in *Joiner* and *Howey* which made the second trust deed notes "securities".

The Court's charge to this jury on this basic issue was at best equivocal and constituted prejudicial error.

The jury was instructed that the sale of a "security" would be established if it found that the trust deed notes or trust deeds were "notes" or "evidences of indebtedness" as defined by the Act. No definitions were given and no guide lines were set forth to illuminate the meaning of "notes" or "evidences of indebtedness".

Although the Court instructed the jury at length on the tests to determine whether that which was sold was an "investment contract", and for that reason a security, the jury was left with a simple alternative requiring only a finding that a trust deed note was a "note". The adequacy of the instructions given on the tests for an "investment contract" is moot since the jury armed as it was with what was tantamount to an invitation to find the trust deeds to be "notes" under the Act, undoubtedly never reached the more involved decision posed by the "investment contract" issue. This seems more compelling in consideration that for some six weeks the jury heard the word "note" perhaps a thousand times.

The basic issue as to Counts One, Two and Four through Seventeen was whether or not that which was sold constituted a "security".

A conviction ought not to rest on an equivocal direction to the jury on a basic issue. Where there are erroneous instructions on a basic issue, a conviction cannot be sustained on some other theory even though the Appellate Court is left with no doubt that the defendant is guilty. *Bollenbach v. United States,* 326

U. S. 607, 613; *Weiler v. United States,* 323 U. S. 606, 611; *Yates v. United States,* 354 U. S. 298, 327.

Cf. Roe v. United States, 5th Cir. 1961, 287 F. 2d 435, 440, where the Court said relative to an instruction which substantially instructed a verdict:

> ". . . No fact, not even an undisputed fact, may be determined by the Judge. The plea of not guilty puts all in issue, even the most patent truths. In our Federal system, the trial court may never instruct a verdict in whole or in part."

II.

The Court Erred in Giving a Summary of a Prior Civil Action Which Had Been Initiated Against the Defendants by the Securities and Exchange Commission to the Jury and Further Erred in Not Giving a Cautionary Instruction After Having Given the Summary of the Civil Trial.

The questions here are (1) whether a judgment in a prior civil case is admissible in a subsequent criminal trial involving the same parties, and was it proper to give a summary of the judgment in the prior civil case in the instant action. The summary was given by the Court [R. 3027] (see footnote 15, *supra*), and (2) having given the summary did the Court properly instruct the jury as to the different burdens of proof required in civil cases and criminal cases.

A. The giving of this summary constituted plain error (18 U. S. C. A., Rule 52, see Appendix). There is no question but there had been a civil trial, but in examining paragraph 11 of Count One of the indictment one finds that the indictment was artfully drawn for the express purpose of laying the founda-

tion to bring in the highly prejudicial, inflammatory and immaterial evidence of the judgment in the prior civil matter.[26] The Government apparently contends that the defendants had a duty during all of the civil proceedings to somehow advertise and advise every customer or prospect that they were being accused of fraud, deceit and misappropriation of their customers' funds and this failure to so advise itself amounted to constructive fraud. That is to say, that the failure of the defendants to advise everyone of the accusation in the civil matter, even before the civil matter was litigated

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[26]Clerk's Transcript, Vol. 2, p. 128, paragraph 11. (Paragraph 11, Count one of the Indictment.)

"It was further an element of said scheme and artifice to defraud that the defendants in order to deceive and mislead investors, and to induce them to invest and re-invest under said secured ten per cent earnings program, would and they did falsely and fraudulent represent to investors that the secured ten per cent earnings program constituted a legal and legitimate investment program which conformed to all applicable laws, and that "legal aspects of all ten per cent earnings accounts have been evaluated and approved by counsel for the company, Mr. Morgan Cuthbertson former counsel for the Securities and Exchange Commission", when in truth and in fact, as the defendants well knew, but concealed from and omitted to state to investors, TD&ME, LATD&ME, TD&MM and the defendants David Farrell, Oliver J. Farrell and Stanley C. Marks were defendants in an action brought by the Securities and Exchange Commission, an agency of the Government of the United States, charged with the administration and enforcement of the Federal Securities Laws to restrain and enjoin them from engaging in acts and practices in violation of the registration and anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 for the appointment of a receiver for TD&ME, LATD&ME and TD&MM based on allegations of fraud, deceit and insolvency; and it was further an element of said scheme and artifice to defraud that, after trial on the issues existing between the Securities and Exchange Commission and the said defendants, in the course of which defendants' course of fraud, deceit and misrepresentation was exposed, and the defendants would and they did continue to solicit and accept

and judgment rendered, amounted to fraud. Whereas, in truth and in fact, such litigation, including all of the pleadings and allegations were and always have been a matter of public record, and it is further submitted that this civil case was given excessive publicity in newspapers and magazines and on radio and television throughout the United States. This, in effect, would effectively deprive the defendants of their property and livelihood without due process of law.[27] They were placed in a position of either flying a red banner over their doors to the effect, "we are accused of fraud, deceit and misappropriation of our customers' funds, but we still would like to do business with you", or the alternative, of closing their doors and ceasing to do business without having their day in court, or being allowed the due processes of law to determine whether they were or were not to be put out of business by the Government. This is manifestly unjust, unfair and effectively prevented the defendants from having a fair trial in the criminal proceedings.

B. The Court further committed error in giving its summary of the civil trial in not at least instructing on the different burden of proof required in a civil action from that required in a criminal action.[28] As early

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deposits of funds from investors under the secured ten per cent earnings program, without disclosing or making known to such investors the nature and import of the proceedings brought by the Securities and Exchange Commission, or the fact that the funds deposited by investors under the secured ten per cent earnings program might be made subject to administration in the course of receivership.

[27]United States Constitution, 5th Amendment.

[28]*Roe v. U. S.*, 5 Cir. 1961, 287 F. 2d 435:

". . . More than that, this being a criminal case in contrast to the more common injunction proceeding or damage suit under the Act, two principles inescapably apply. First, in

in the trial as the opening statement, Counsel for the Government stated to the jury:

> [R. 32] "You will hear later in this regard how there was litigation going on at this time with the SEC charging, (1) you people are dealing in securities; (2) you are defrauding people; and (3) also, you are insolvent."
>
> [R. 43, 44] "Also, in regard to the litigation pending, think and determine whether the investors were fully informed of the facts when though there was pending litigation charging both the fact that they were dealing with these securities, and fraud and insolvency, the policy was not to tell investors anything at all about the litigation unless they asked. And if they did ask, to tell them that it was just a jurisdictional dispute to see if the type thing that LATD was selling should be handled by the Securities and Exchange Commission.
>
> "Listen closely with regard to whether the investors were told anything about whether there were any charges of fraud and insolvency, regardless of whether they were true or not. Think about whether these investors should have known at least there were charges. Think about whether they should have been able to make their own investigation, possibly. Think about whether they were fully apprised of the facts."

Mr. Justice Jackson's words "in a civil action * * * a preponderance of the evidence will establish the case; * * * in a criminal case, [the evidence must] meet the stricter requirement of satisfying the jury beyond a reasonable doubt." 320 U. S. 344, 355, 64 S. Ct. 120, 125.

One can readily imagine the cumulative damage done by the jury hearing this in the opening statement and then having the judge give the summary, in effect confirming what had been said. It is true that the judge stated that "neither the charges made in the pleadings in such case nor said judgment are to be considered by you as evidence of the truth of such charges." [R. 3027]. This would obviously be closing the gate after the horse has escaped. The difference between the burden of proof required in a civil action and that required in a criminal action is so great that the Court committed grave error when it failed to thoroughly instruct the jury of the difference in the burden of proof. In a criminal action the burden is always on the Government to prove the guilt of the defendant beyond a reasonable doubt. To sustain the burden the Government must prove guilt by substantial evidence, excluding every other reasonable hypothesis than that of guilt.

Fotie v. United States, 8th Cir. 1943, 137 F. 2d 831;

Cataneo v. United States, 4th Cir. 1948, 167 F. 2d 820;

United States v. Bruno, 3rd Cir. 1946, 153 F. 2d 843.

In a civil matter the plaintiff merely has the burden of showing that he is entitled to win.

Pacific Portland Cement Company v. Food Machinery and Chemical Corporation, 9th Cir. 1959, 178 F. 2d 541.

The Court should have given the jury further instruction concerning the fact that the Government in the case at hand has a much greater burden in order to prove that the defendants should be found guilty of the crimes as charged and its failure to do so seriously prejudiced the defendants.

Roe v. United States, 5th Cir. 1961, 287 F. 2d 435 (see footnote 28, *supra*).

C. It is a well settled rule that evidence of a civil judgment will not be admitted into evidence in a criminal matter and conversely, evidence of a criminal verdict will not be admitted in a civil matter.

Monte Green v. State of Indiana, 184 N. E. 183, Ann. 87 A. L. R. 1251.

A case dealing with criminal prosecution of an officer of a bank for receiving a deposit with knowledge of the bank's insolvency a few days before the instituting of receiver proceedings and the prosecution attempted to introduce the records of a prior civil proceeding for the appointment of receiver. It was held that the records of a prior civil proceeding was inadmissible. The Court here correctly pointed out the difference in the burden required in a civil case and that required in a criminal case. The Court pointed out that what might be insolvency and a failing condition sufficient to allow the appointment of a receiver in a civil action, might not be sufficient to establish insolvency insofar as a criminal proceeding is concerned.

It might be said that a judgment is always admissible into evidence to prove the fact of its existence and that it was actually rendered by a Court of competent jurisdiction. In the instant action there had been no final adjudication and, in fact, the judgment which was not entered until May 20, 1960 enjoining the defendants in the civil action was stayed and the injunctive action by the Court further stayed by the Appellate Court although the Receiver went into possession on June 8, 1960. It is inconceivable that the mere fact that there was litigation pending could by any stretch of the imagination be material in the instant action when final adjudication in the civil matter did not occur until long after the Receiver took over control of LATD, and add to that the fact that the Court failed to properly instruct the jury and you have serious error which in and of itself should be grounds for reversing this verdict to provide the Appellant a fair and impartial trial.

Appellant respectfully points out that this summary by the Court was given to the jury at the close of, or immediately prior to, the close of the Government's case. When one considers that the jury received the summary concerning the civil action from the Court and then was allowed to read the contents of the newspaper article using the language of Judge Thurmond Clarke in Exhibit 1950-A for identification, it is evident that the jury was in possession of the ingredients which when mixed rendered a conviction an absolute certainty without the benefit of a free and impartial weighing of the evidence of the jury, and it is apparent that the dangerous ingredients were well mixed in the jury room to produce a grossly unfair decision.

III.

The Court Erred in Allowing Any Testimony of Losses by the Customer-Witnesses in That Such Evidence Was (a) Immaterial and Irrelevant to the Crimes Alleged and (b) Violative of the Court's Own Ruling in Reference to Events Occurring After June 7, 1960. The Instruction of the Court Did Not Cure the Error.

The cutting edge of the Government's case was the selectivity with which customers were chosen to testify and the channels into which the adroit questioning led. The cutting effect of this edge was honed to a sharpness against which there was no effective defense.[29]

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[29]The staging of select witnesses has been deplored by eminent jurists. See concurring opinion of Judge Frank in *United States v. Grayson,* 2d Cir., 1948, 166 F. 2d 868, 870. There the prosecutor had elicited only three bits of inflamatory evidence: did a victim have a son in the service: had a victim paid defendant all that she had in the world and was victim married and did she have a husband in the service. The Judge excoriated this practice:

> "Whether any one of those errors standing alone would be enough to require reversal need not be considered. But combined, I think they deprived defendant of a fair trial; they come within the recent rulings of the Supreme Court defining prejudicial as distinguished from harmless error. The able and conscientious trial Judge, patently troubled by this unfairness, once severly criticized government counsel out of the presence of the jury, regularly directed the improper testimony to be stricken, and gave disregarding instructions. I think, however, he should have gone further and declared a mistrial. *For the objectionable answers, once given, had such a character that no one can say that the judge's warnings effectively removed their poisonous consequences. Indeed, as experienced trial lawyers have often observed, merely to raise an objection to such testimony—and more, to have the judge tell the jury to ignore it—often serves but to rub it in.* I believe that a prosecutor ought not deliberately and repeatedly, as here, put defendant's lawyer in such an awkward dilemma—where his client will suffer if the lawyer does not object or if he does. *If, without attaching any practical consequences to such tactics of the*

The sympathy effect on the jury of the testimony of Mr. Lees [R. 1806] who was 69 years of age, hard of hearing and unemployed; of Mr. Campbell [R. 1846-1847] who was 87 years of age and whose wife had to go to the County Hospital; of Mr. Schanz [R. 1820] who was 72 years of age, hard of hearing and obviously a man of no formal education; of Mrs. Hlavka [R. 1789] a widow; of Mrs. Eppley [R. 719] a 72 year old widow, was overwhelming. It was calculated to be.

Neither allegations nor proof of losses or that any one was actually defrauded was required. *Bobbroff v. United States,* 9th Cir. 202 F. 2d 389; see also *Hermansen v. United States,* 5th Cir. 1956, 230 F. 2d 173. If such testimony was unnecessary it was therefore immaterial; why then did the Government try to prove the unnecessary? The only answer is that it was calculated to engender sympathy for the alleged victims and conversely antipathy against the defendants whose guilt or innocence the jury was soon to be called upon to judge.

It will be argued that Appellant's counsel by failing to object waived the objection and perhaps it is well taken. But perhaps the Appellant's attorneys were impaled on the horns of the dilemma noted and severely criticized by Judge Frank.

However, were this the only ploy used by the Government the severity of the error would not be so compelling. But, coupled with the finale scheduled for each witness' testimony as to not getting his money back,

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prosecutor, we simply express disapproval of them, we do nothing to prevent their repetition at the new trial of this case or in trials of other cases." (Emphasis added.)

the net effect was overwhelmingly prejudicial. There was a further ground upon which losses were inadmissible. This arose out of the fact a receiver took over a going business and the defendants had no control of events thereafter. The Court, as pointed out above, attempted to establish the date of take over by the Receiver as an effective barrier beyond which neither the Government nor the defendants would go. Admittedly, much evidence of events that occurred after the Receiver was rejected.

However, on evidence of customer losses, this salutary barrier simply did not exist for the Government and it was free to roam on up to as late as the very day that the witness was testifying almost two years beyond the cutoff date. At the same time Appellant was effectively blocked in his pursuit of such evidence in order to rebut it. This was the source of constant objection and discussion with the Court as seen above.

There can be no doubt of the validity of Appellant's position on the need for an effective cutoff date. However, the administration and application of the rule, as applied on evidence of losses, was manifestly unfair. The maximum latitude that can be said to be allowed to the prosecution in this case would be to inquire *if* the customer had *tried before June 8, 1960* to convert his position to cash and if he had, what happened? The Court, on one occasion, suggested this as representative of its ruling but it was observed only in the breach by the prosecution.

Finally the question is asked if the Court's instruction [R. 4304] was not curative of the problem. That the Court was concerned with the admission of loss

testimony is evident not only from the discussion [R. 3614] but also from the attempt by the Court to correct the error with an instruction withdrawing customer losses entirely from the jury's consideration [R. 4304]:

> "You shall disregard any evidence or testimony of Los Angeles Trust Deed & Mortgage Exchange and affiliated companies to the effect that a loss was suffered after June 7, 1960. The defendants are not charged with responsibility for acts occurring after that date."

Unfortunately, the Court omitted four words contained in the copy of his proposed instructions given to Appellant's counsel. In the copy the instruction was worded as follows:

> "You shall disregard any evidence or the testimony *of any customer of* The Los Angeles Trust Deed & Mortgage Exchange and affiliated companies to the effect that a loss was suffered after June 7, 1960. The defendants are not charged with responsibility for facts occurring after that date."[30]

The omitted words were indispensable to the instruction. Without them it was meaningless much less helpful in curing the error. Since there had been no testimony of Los Angeles Trust Deed & Mortgage Ex-

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[30]The inclusion of the four words on the judge's proposed instruction and omitted in his actual instruction were contained in a copy of the judge's proposed instruction turned over to Appellant's present counsel by former counsel. It is assumed that the Government's copy of the proposed written instructions also contained these four words and, unless the government takes a contrary position in its reply brief, it will be assumed to be a correct statement of the occurrence.

change there was really nothing for the jury to disregard.

It is submitted, however, that even had the judge read his proposed instruction correctly it would not have undone the severity of the error.

Cf. Lockhart v. United States, 9th Cir. 1929, 35 F. 2d 905, citing with favor *Waldron v. Waldron,* 156 U. S. 361, 15 S. Ct. 383, 39 L. Ed. 453. See also the dissenting opinion of Judge Frank in *United States v. Antonelli Fireworks Co.,* 2nd Cir. 1946, 155 F. 2d 631, for an exhaustive treatise on the subject of prejudicial misconduct and error. See also Judge Frank's concurring opinion in the *Grayson* case, *supra. Cf. Kotteakos v. United States,* 328 U. S. 750, 66 S. Ct. 1239, 90 L. Ed. 1557; *Bihn v. United States,* 328 U. S. 633, 66 S. Ct. 1172, 90 L. Ed. 1485; see also *Bollenbach v. United States,* 326 U. S. 607, 66 S. Ct. 402, 90 L. Ed. 350; *Weiler v. United States,* 323 U. S. 606, 65 S. Ct. 548, 89 L. Ed. 495, 156 A. L. R. 496; *Bruno v. United States,* 308 U. S. 287, 293, 60 S. Ct. 198, 84 L. Ed. 257.

If it is argued that any objection to the wording of the instruction on loss was waived because Appellant's counsel did not take exception thereto, it is respectfully submitted the omission of the four words went unnoticed by any one in the courtroom, including the judge for it seems clear the Court was concerned about the error. The failure to catch it was excusable.

In summary, it is submitted that the errors complained of were prejudicial and constitute sufficient grounds standing alone to warrant reversal. Obviously the error was not corrected by the Court's instruction;

nor could any instruction have cured the error already created in the jury's mind. Furthermore the error when taken in conjunction with the other errors assigned, make it clear Appellant did not receive that which he deserved—a fair trial.

IV.

The Court Committed Plain Error in Allowing the Introduction of Plaintiff's Exhibit 6003.

Exhibit 6003 was originally presented to the court in a box containing two baskets filled with approximately 800 so-called "sell orders," each of which was basically a small sheet of yellow paper instructing LATD to liquidate the customer's account. The actual request to liquidate may be a document which would be kept as a matter of routine business practice. However, Exhibit 6003 is found to contain in addition to the business form, hundreds of personal letters written in longhand or typed from customers to LATD and in addition, containing numerous notations by parties unknown. The most shocking item found in Exhibit 6003 was a newspaper clipping containing the same prejudicial and inflammatory language as Exhibit 1950-A for identification, which was offered by the Government into evidence, but was rejected by the court at [R. 2870]. The letters are from various customers of LATD and a cursory examination of these letters will readily disclose that they contain highly inflammatory and prejudicial material in addition to being hearsay in the extreme (see appendix summary).

Exhibit 1950-A for identification appears to have been a copy of a document indicating the way the trial judge would rule in the civil case tried prior to the

instant action entitled "Securities and Exchange Commission v. Los Angeles Trust Deed & Mortgage Exchange, et al.," 187 F. Supp. 830 (9th Cir.), using the same language as that used by the Honorable Thurmond Clarke in said case (see Appendix p. 28 stating the language which appeared in Exhibit 1950-A). This comment by Judge Thurmond Clarke was of a highly inflammatory nature and this newspaper article alone is so prejudicial that it in itself would be sufficient to incite the jury to such anger as to render it impossible for them to sit in calm, dispassionate judgment of the defendants, rendering a fair and just verdict impossible. In addition to the contents of Exhibit 1950-A for identification the hundreds of letters from customers containing highly inflammatory, prejudicial and hearsay evidence would, to say the least, be sufficient to cause members of the jury to become inflamed to such an extent that they could not render an unbiased, unprejudiced decision. This appellant desires to point out the following sequence of events which occurred during the course of the trial which set the scene for the court allowing Exhibit 6003 into evidence [R. 1664]. Counsel for the Government addressed the court concerning Exhibit 6003 to the effect that the box he was talking about containing the liquidation records was not going to be introduced into evidence in the case, but was just marked.

> "We don't intend to use anything in that box, Sir." [R. 1665].
>
> "We are not going to introduce them and take the time of the court, but we just wanted them available to defense counsel."

Again, at [R. 2871] counsel for the Government stated, referring to Exhibit 1950-A for identification (rejected by the court at [R. 2870]), the language of which was contained in a newspaper clipping in Exhibit 6003.

> "It isn't the language that we are interested in, Sir. We will knock all that out. It is just that we cover in some instruction the significance of the date bearing on the good faith of the defendants, that date along with the May 20th date."

Again [R. 2789], referring to the so-called documents in Exhibit 6003:

> "We don't intend to put any of these things in. I am just trying to clear what they are. I won't put these in, but I want the witness to testify from them so it is clear what he is talking about."

Then at [R. 2793] the Government suddenly produces a summary prepared by Witness Leroy Cole, designated Government's Exhibit 6002 [R. 2793], which purported to be a list of customer demands for liquidation prepared by Cole after the Receiver took over on June 8, 1960. The Government offered Exhibits 6002 and 6003 into evidence [R. 2795-2796] and an objection by the defendants was sustained by the court on the grounds that Exhibit 6002 and Exhibit 6003 were based upon certain documents which were not present in court. The court then allowed Exhibit 6003 and Exhibit 6002 into evidence after asking these questions:

> "Were these requests [Ex. 6003] part of the books of the Company when you went to make the audit at the time you assisted in taking over?

"Were they in the possession of the Company at that time?"

An affirmative answer was received from the witness. At the same time the court overruled the objection of the defendants that there was no proper foundation, and that Exhibit 6002 and Exhibit 6003 were irrelevant and incompetent [R. 2799-2801]. The court then immediately instructed the jury [R. 2800] that Exhibit 6002 would be admitted but that Exhibit 6002 was not evidence in itself; that if there was *any evidence or anything of materiality or relevancy* (emphasis added), it would be in connection with Exhibit 6003 that Exhibit 6002 was merely a summary for convenience if the jury wanted to use it for that purpose.[31] Later, as if to compound the emphasis the court [R. 4007-4008] again admitted Exhibit 6003 into evidence.[32]

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[31] [R. 2800]:

"The Court: It will be admitted but the jury is instructed that it is not evidence in itself. If there is any evidence, or anything of materiality or relevancy which you will consider, it is in connection with 6003. That is, 6002 is merely a summary for convenience, if you want to use it for that purpose. 6002 is admitted."

[32] [R. 4008]:

"Q. By Mr. Dunn: I place before you Government's Exhibit 6003—

I assume that is in evidence, your Honor.

The Court: Would you check, Mr. Clerk?

Mr. Medvene: If it is not in, the Government would offer it at this time so the question can be asked.

The Court: Let's see if it is in.

Mr. Dunn: It is my understanding that the summary is not in.

The Court: I am not certain which.

Mr. Medvene: The summary is not in—the summary is in, but I don't think the Exhibits are in. The Government would move them in at this time.

The Clerk: I don't have them in, your Honor.

The Court: All right. Admitted."

Keeping in mind the statements and representations by Government counsel that they were not going to put the mass of material contained in Exhibit 6003 into evidence and the strict admonition by the court [R. 3043-3044][33] directing the Government to excise

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[33] [R. 3043-3044]:

"Mr. Dunn: Prior to recess, may I mention one thing, your Honor?

The Court: Yes.

Mr. Dunn: I wish to take exception to the court's requirement that the defendants have counsel over the weekend look at the documents which have been provisionally admitted on this ground: That as early as January of this year, in our first pretrial conference, these objections were raised and called to the attention of Government counsel prior to entering into any stipulation, and then we were put under a rule that until we stipulated to certain documents, we could not see additional documents. We wasted hours and hours.

Now, we have an entire weekend of work planned, with very little rest, your Honor, and to be here at that time will hamper the defense immeasurably, and I believe that it is an onerous burden to place on us when the Government knew of these objections and knew they were going to be made and made no provision to take care of them prior to presenting these documents to the court.

Therefore, I vigorously object to that requirement being made at this time.

The Court: I will rule promptly on it. It won't be necessary that defense counsel be here. I place on the Government the burden of the removal of the objectionable material.

Mr. Dunn: Thank you, your Honor.

The Court: Is there anything else before the recess?

Mr. Medvene: Just as a matter of good faith, your Honor, we will take off the material that it is our understanding is objectionable, and if there is any question about that, I think the ball will then have to be passed to the defendants.

The Court: We will settle that right now.

Mr. Medvene: Yes, sir.

The Court: You take the exhibits and remove the material. After all, the ruling of the court has not been too specific on that, either. Remove the material now, whatever seems to be outside of the document itself, writings that seems to be outside of the documents and to which

all extraneous and immaterial matter from the various multi-page exhibits prior to it being given to the jury, it becomes obvious that Exhibit 6003 should not have been admitted into evidence and submitted for examination by the jury in its then condition containing the innumerable immaterial, irrelevant, incompetent, inflammatory and hearsay items. The court apparently felt that Exhibit 6003 was the type of document which would come within the provisions of 28 U. S. C. §1732. (see Appendix p. 30). It appears that the court, basing its ruling upon the representations of Government counsel and Government Witness Cole, and having in mind the fact that the court had admonished and directed the Government that it [the Government] had the duty to excise all extraneous immaterial matter from the exhibits before giving them to the jury [R. 3043-3044], committed serious error in allowing this highly prejudicial mass of material to be dumped into the lap of the jury.

It is respectfully submitted that the court committed further error in admitting Exhibit 6003 on the following additional grounds:

(a) Exhibit 6003 was not a business record, but was merely hearsay, containing information and docu-

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objection was taken, and then keep those documents separate and apart, and at a proper time we will submit those documents to counsel for the defendants. Then we may have the objections to any material that has not been removed.

Mr. Medvene: Yes, sir, the only reason that we made our request, sir, was we didn't want to touch the documents unless the defendants were present.

The Court: That is all right."

ments which even the Government and the trial judge knew and admitted should be excised, which information and documents were all so inflammatory and prejudicial that they themselves could, and probably did, cause the jury to convict the defendants. Exhibit 6003 contained letters from customers which obviously were not records of the defendants and should not have been admitted as a business record.

Amtorg Trading Corporation v. Higgins, 2d Cir. 1945, 150 F. 2d 536.

In the *Amtorg* case the court held that letters and statements from buyers to the seller that the buyer had paid excise tax on certain goods imported from Russia, did not come within the category of "business records", hence were inadmissible hearsay in the prosecution against the seller.

A memorandum or record cannot be considered as having been made in the regular course of business within the meaning of this section relating to admissibility of business records unless it was made by an authorized person to record information known to him or supplied by another authorized person.

Standard Oil Company v. Moore, 9th Cir. 1957, 251 F. 2d 188, Cert. den., 78 S. Ct. 1139, 356 U. S. 975, 2 L. ed. 1148;

Schmeller v. United States, 6th Cir. 1944, 143 F. 2d 544.

In the *Schmeller* case the court had before it a situation involving prosecution by the Government for manufacturing defective war materials. The trial court admitted enmasse, Exhibits 1 to 46 constituting a group of documents, some unsigned and some containing hearsay matters taken from the files apparently kept in the regular course of business. The court held that the mere fact that paper offered into evidence is taken from a business file and is otherwise acceptable, does not render or establish its competency and that such should have been excluded. The court should have ruled upon each paper separately and should have excluded the hearsay and other incompetent evidence. In the instant action Exhibit 6003 appears to contain nothing but hearsay since most of the liquidation requests were prepared by the customers themselves and would obviously contain hearsay matter, but assuming for the sake of argument that the liquidation requests themselves were relevant, material, competent and not hearsay, all of the other documents attached to the liquidation requests were so clearly irrelevant, immaterial, incompetent, inflammatory and so violative of the hearsay rule that they should have been excluded. It is further pointed out that the actual liquidation requests constitute a mere fraction of the substantial bulk of Exhibit 6003.

(b) It is further respectfully submitted that the liquidation requests themselves, excluding all of the letters, notations and other extraneous matters, were im-

material in the instant action because a simple examination of the record discloses that the liquidation requests were apparently offered to show that the defendants were unable to liquidate a customer's account according to the wording of the brochures. These liquidation requests did not tend to prove or disprove any issue in the case. Exhibit 1668, which is the so-called green export brochure sent out to all past and present customers and prospects of the defendants, clearly sets forth that liquidation or sell orders will be handled "on a best effort basis only." It is clearly set forth in Exhibit 1668 that LATD did not guarantee anything except "best efforts." This language is also contained in Exhibits 844, 1670, 1673 and 1674 (see Appendix pp. 34, 35). There is no evidence or testimony in the entire record indicating that "best efforts" were not used. Why would the fact that a substantial number of sell orders came in between May 3, 1960 and June 7, 1960 (one day before the Receiver took over) be material to any issue in this case They would be no more material than a sell order or a liquidation request received after June 8, 1960. Further, there is no evidence nor exhibits indicating on what date liquidation was to take place. Apparently the liquidation request cut-off date was arbitrarily determined by the court to be June 7, 1960, but there is nothing in the record to support this arbitrary action.

(c) The allowing of Exhibit 6003 into evidence after the Government advised repeatedly that it was not

going to submit the exhibit into evidence and was not going to use it [R. 1664, 1665, 2871 and 2789] and without the Government excising the immaterial prejudicial inflammatory items included in 6003, even though ordered to do so by the court [R. 3043-3044], so greatly prejudiced the position of the defendants that it cannot be considered mere harmless technical error; rather it was so grave as to effectively deprive the defendants of a fair and impartial trial. When one reads the highly inflammatory, to say the least, immaterial and hearsay matters contained in the letters from various customers to the defendants contained in 6003, it becomes obvious that a fair trial was impossible, especially after the court instructed the jury that the summary, Exhibit 6002, was not the evidence, but that they were to look to 6003 as being the real evidence. Appellant respectfully submits that the items contained in Exhibit 6003 were not documents kept or maintained by the defendants in the routine course of business, that they were immaterial, irrelevant, incompetent and hearsay and that further, they were so highly inflammatory and prejudicial as to tip the scale by passion and prejudice in a case which was finely balanced. The question is what effect did the error have, or reasonably may be taken to have had, upon the minds of the jurors in the total setting. Here one pictures the jury, its attention focused on this exhibit not only by its appearance but by the court referring to it as primary evidence, reading hundreds of letters from

irate customers, elderly people, people who claimed to have put their moneys into LATD to provide for their children, who needed the money for illness, and every other pathetic situation one can imagine, and then one can readily see that it was impossible for the jury to have a clear and impartial mind with which to approach the problem of weighing the evidence in this case.

(d) It is further respectfully submitted that Exhibit 6002 is not a true summary of Exhibit 6003 as represented to the court by Government witness Cole.[34] Had Exhibit 6002 been a true summary of the content of Exhibit 6003, the Court would have rejected both Exhibit 6002 and Exhibit 6003. For Exhibit 6002 to be a true summary of Exhibit 6003 would require a complete summarization of all items contained in Exhibit 6003. Unless the Court examined Exhibit 6003 in detail there would be no way for the Court to be made aware of its true contents (see Appendix pp. 21-27).

Witness Cole testified that Exhibit 6002 was a synopsis of "demands" contained in Exhibit 6003 [R. 2793] and at [R. 2794] sell orders contained in Exhibit 6003 are "summarized" in Exhibit 6002. At [R. 2797] Cole testified "we made a summary of the requests for liquidation that were on hand on June 8th"

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[34]Webster's New 20th Century Dictionary, Unabridged, defines the term SUMMARY as a short, abridged, or condensed statement or account; an epitome or abstract; an abridgement or compendium containing the sum or substance of a fuller statement.

and the court apparently believing that Exhibit 6002 was truly a summary of all the contents of Exhibits 6003 admitted the exhibits. Appellant submits that Exhibit 6002 was not a summary of Exhibit 6003 using the plain definition of summary nor was it a summary in actuality since it contained no reference to the many items contained in Exhibit 6003.

Conclusion.

A sound argument in support of Appellant's position is contained in the whole record if approached and reviewed with a calm objectivity. It is a large record to review, yet the issues are grave involving as they do a severe loss of liberty. Perhaps it is with this sense of urgency that the arguments made herein have been presented and in that light, if excessive, can be understood and forgiven.

The points raised herein are valid and warrant reversal.

The errors expressed merely indicate ideas which can find sound support in the record as a whole. Appellant respectfully urges that the Court reverse the conviction and return the matter to the Court below to be disposed of with complete fairness and finality.

Respectfully submitted,

James A. Poore and
Robert G. Clinnin,
Attorneys for Appellant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

JAMES A. POORE,
Attorney.

APPENDIX.

Index of Exhibits.

Code of abbreviations: "P" admitted provisionally
"I" marked for identification

Number	Page
508-509	1788
516-523	1035
524-525	1959 "P"
526-532	1959
534-535	1959
536-537	1851
537-A	1850
538	1852
540-543	1852
546-551	1971
553-559	1971
561-569	2015
577-582	2178
582-A	2178
583-587	2224
587-A, 587-B	2224
588-592	2625
594-605	2625
606-607	2627
611	2627
613, 615	2627
620-624	2215
625-627	1986
628-635	1986
637	1986
640	1986
641-A	1986
642	1986
645-646	2968
646-A	2968
647	2968
647-B	2968
648-649	2619
650	356 "I"

Number	Page
1638-1639	174 "I"
1641	281
1642	242
1643-1644	263
1645	115
1650	281
1651	281
1652	305
1653	171
1654	112 "I"
1655-1656	207
1657-1658	291
1660	257
1663	174 "I"
1664	174 "I"
1664-A	174 "I"
1665	174 "I"
1666	514
1667-1668	654
1669-1670	514
1671	654
1672	514
1673	654
1674	514
1719-1720, 1722	1111
1721-1724	1113 "P"
1727	1157
1728	1173
1739-1740	1157
1741-1742	1181
1747	1544
1750	1544
1844-1892	1479
1893	2745

Impeachment Exhibits

Summary of Information in 6003.

The following is a summary of information contained in Exhibit 6003 listed by account number, customer's name and date, giving a brief statement as to the contents set forth in the innumerable sell orders or requests for liquidation:

No. 4703 — Joseph Pearson, letter dated May 6, 1960, reference by customer to a newspaper article by Judge Thurmond Clarke.

No. 4496 — Chester F. Gellibray, letter dated May 9, 1960 to effect that customer put their money in to purchase a home.

No. 4901 — Virginia Shannon, letter dated June 6, 1960, which is handwritten by customer stating she has lost three members of her family and desperately needs the money which she has on deposit with LATD.

No. 4842 — Ray E. Bardin, letter dated May 23, 1960, which is written by customer in longhand, requesting that money be returned "for sure" this time.

No. 4830 — A. C. Hillman, letter dated May 6, 1960, which contains a reference to Judge Clarke's statement.

No. 4994* — Arthur D. Terflinger, letter dated May 6, 1960, written in longhand by depositor who states that the depositor is 74 years old and cannot afford to lose this great sum.

No. 2815 — Thomas M. Cagle, letter dated May 7, 1960, which contains notation that the customer needs the money to buy a new home.

No. 2777* — Floyd W. Lemons, letter dated May 23, 1960 is a handwritten letter that the customer is getting married and needs the money to purchase a house.

No. 2742* — J. E. Whiston, letter dated June 2, 1960, which is handwritten from the customer that the customer needs the money to put their mother in a nursing home.

No. 3440* — Mary E. Spilman, letter dated May 17, 1960, which contains correspondence from a lawyer and another letter.

No. 3812* — Thomas Watson, letter dated May 25, 1960 stating that the customer needs the money to help his brother who is very ill.

No. 1300 — Customer Whittaker, letter dated May 10, 1960, complaining that the customer was told that customer could get his money back within a couple of days.

No. 1366 — J. W. Benjour, letter dated May 10, 1960, stating that the defendants attempted to prevent liquidation of the customer's account in the sum of $54,000.00.

No. 1680 — Russell Smith, letter dated May 31, 1960, written in longhand complaining that the customer is unable to get money as promised.

No. 2045 — Customer Rothwell, letter dated May 9, 1960 stating that the customer was told that he could withdraw his money within a very short time.

No. 2291* — Chester Jones, letter dated May 26, 1960 stating that customer has lost his job and needs the money.

No. 2417* — John T. Argus, letter dated May 17, 1960 containing the statement, "trusting in you as before."

No. 2954* — Customer Leslie, letter dated May 16, 1960 stating that the customer is in the midst of a dire emergency.

No. 20479 — Peter Bell, letter dated June 3, 1960, referring to the litigation and newspaper articles.

No. 9735 — Customer Slabicki, letter dated June 6, 1960 written in longhand and stating that customer is in need of money.

No. 9832 — Alice Fleming, letter dated May 27, 1960 stating that customer is faced with an emergency and needs money.

No. 9893 — Abraham Koretski, letter dated June 1, 1960 stating to the effect that there is illness in the family and the customer needs his money.

No. 9920 — Customer Page, letter dated May 25, 1960 stating that customer has just invested his money and wants it back.

No. 20175 — Customer Yunch, letter dated June 1, 1960 relating that he is faced with an emergency and needs money immediately.

No. 20208 — Forrest Class, letter dated May 25, 1960 stating that he needs money and he never got his trust deed.

No. 20414 — Customer Padden, letter dated June 6, 1960 written by an obviously uneducated person, asking for money and telling Mr. Farrell that he should not be afraid.

No. 20850 — Customer Mann, letter dated May 19, 1960, stating that he is faced with an emergency and needs his money.

No. 20874 — Customer Heiter, letter dated June 6, 1960 stating that it is urgent and needs money.

No. 6909 — Edwin S. Hanna, D.D.S., letter dated May 6, 1960 in which he says customer did not get a trust deed on improved property in Orange County and "wants refund according to policy of giving refund at any time."

No. 8185* — Customer Dean, letter dated May 19, 1960 stating that the customer has suffered drastic misfortune and needs money.

No. 8295 — Customer Zeckiel, letter dated May 6, 1960 stating "I had hoped that this would be foundation for Carolyn's (12) college education.

No. 8456 — Customer Wheeler, letter dated May 10, 1960 containing reference to adverse publicity.

No. 8590 — Customer Germain, letter dated May 9, 1960 from a farmer, requesting withdrawal and stating that he had been told he could withdraw funds at any time.

No. 6888* — Customer Moots, letter dated June 1, 1960 containing a notation in handwriting "urgent to Farrell, needs money."

No. 7090 — Customer Miner, letter dated May 24, 1960 stating that the customer had been told he could withdraw money at any time.

No. 7097* — Henrietta Moch, letter dated May 24, 1960 stating customer is sick and was told she could get her money at any time: states that customer cannot work.

No. 7154* — Customer Benjamin, letter dated June 1, 1960 stating that customer is unemployed and needs the money.

No. 7173 — Customer Gebhard, letter dated June 6, 1960 stating that customer's husband is sick and needs the money.

No. 7663 — Customer Edelman, letter dated May 16, 1960 stating that the customer is faced with an emergency and needs the money.

No. 8910 — Customer Pastorelli, letter dated May 24, 1960 stating that customer is faced with an emergency and needs money.

No. 9143 — Eve M. Greene, letter dated May 17, 1960 with a scrap of paper attached to it with printing stating, "your request complete, close out today, wants check by 2:05 20th of this month advise customer impossible."

No. 9151 — Customer Steele, letter dated May 10, 1960 speaking of "investment."

No. 9204* — John R. Clarke, letter dated May 26, 1960 referring to article in the Wall Street Journal and wants money back before it is tied up by the court.

No. 9416 — Customer Brun, letter dated May 23, 1960 to the effect that the customer does not want a subordinated trust deed.

No. 9463* — Elizabeth Smith, letter dated May 27, 1960 stating that customer is unable to work and has her life's savings involved and wants her money back.

No. 9502 — Customer Uranon, letter dated May 24, 1960 referring to liquidation of the corporation (LATD).

No. 5818 — Customer Hoffmeyer, letter dated May 25, 1960 stating that the customer is not happy with the method of operation and wants money back.

No. 5887* — Customer Domitio, letter dated May 31, 1960 stating that the customer is in poor health and needs the money.

No. 6107* — Customer Wurzboch, letter dated May 23, 1960 to the effect that he is too old to acquire real estate; that his wife worries too much; that he needs the money.

No. 6314** — Edmund R. Meitus, letter dated May 5, 1960. This is a very long letter from an attorney by the name of Edmund R. Meitus, severely criticizing the manner of operation of LATD and demanding his money back. Also comments extensively that he doesn't go along with Judge Clarke's judgment in the civil case, but that he still feels that the defendants were not operating correctly. Attorney Meitus was a customer of LATD.

No. 6675* — Customer Olsen, letter dated May 24, 1960 stating he has incurred substantial doctor bills and needs the money immediately.

*Appellant does not set forth all of the letters contained in Exhibit 6003 but has merely, as the Government stated in its opening Statement [R. 33] selected a sampling of letters as just part of the entire picture presented in Exhibit 6003. Each letter has been pointed out for the purpose of giving the court a different aspect as to the over-all tremendous impact contained in Exhibit 6003 and denotes letters which would move the most hardened heart to extreme compassion.

**This letter would obviously have a devastating effect upon the minds of the jurors. It is a detailed attack on the operations of LATD from a person who was not only an attorney, but was a customer of LATD.

Newspaper Article.

LOS ANGELES HERALD EXPRESS
U. S. JUDGE BLASTS
"TEN PER CENTERS"

Blasting at so-called "10 per centers who mislead countless small investors," Federal Judge Thurmond Clarke today ordered the Securities and Exchange Commission to file their conclusions and proposed judgment in that field.

The action was taken in a case involving the Los Angeles Trust Deed and Mortgage Exchange which Judge Clarke has been hearing for the past three months. The commission had asked for a permanent injunction against the firm continuing operations except under a receivership.

The Judge said that his order, to be answered by next Wednesday, was not an immediate judgment but he clearly indicated that he would be strongly advised by the pending conclusions of the commission.

ALERTS PUBLIC

Judge Clarke said he wished to alert the public to the dangers of investing in the home building industry by way of the sale of second mortgages, among other schemes, and added:

"These 10 per centers have developed an ingenius and thoroughly devious scheme relying on legal loopholes.

"It is their good fortune that the scheme has not yet come tumbling down around their heads, like the frail cardhouse structure it is.

"This case has unearthed many totally unethical practices which run a very close line between criminal prosecution and civil actions for fraud.

"The court regrets that the processes of law have worked so slowly that the hearth of many innocent investors have been placed in jeopardy," the Judge concluded.

CALLED TEST CASE

Legal experts have termed the trial a test case challenging the right of the regulatory commission to embrace the field of real estate loans.

David Farrell, President of the mortgage exchange firm stated that the record will show "no instance in which we have issued a security or an investment contract."

United States Statutes.

28 U. S. C. A. §1732. Record Made in Regular Course of Business: Photographic Copies

(a) In any court of the United States and in any court established by Act of Congress, any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence, or event, shall be admissible as evidence of such act, transaction, occurrence, or event, if made in regular course of any business, and if it was the regular course of such business to make such memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter.

All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but such circumstances shall not affect its admissibility.

The term "business," as used in this section, includes business, profession, occupation, and calling of every kind.

(b) If any business, institution, member of a profession or calling, or any department or agency of government, in the regular course of business or activity has kept or recorded any memorandum, writing, entry, print, representation or combination thereof, of any act, transaction, occurrence, or event, and in the regu-

lar course of business has caused any or all of the same to be recorded, copies, or reproduced by any photographic, photostatic, microfilm, micro-card, miniature photographic, or other process which accurately reproduces or forms a durable medium for so reproducing the original, the original may be destroyed in the regular course of business unless its preservation is required by law. Such reproduction, when satisfactorily identified, is as admissible in evidence as the original itself in any judicial or administrative proceeding whether the original is in existence or not and an enlargement or facsimile of such reproduction is likewise admissible in evidence if the original reproduction is in existence and available for inspection under direction of court. The introduction of a reproduced record, enlargement, or facsimile does not preclude admission of the original. This subsection shall not be construed to exclude from evidence any document or copy thereof which is otherwise admissible under the rules of evidence. As amended Aug. 28, 1951, c. 351, §§1, 3, 65 Stat. 206; Aug. 30, 1961, Pub. L. 87-183, 75 Stat. 413.

18 U. S. C. A., Rule 52 "Federal Rules Cr. Proc. Harmless Error and Plain Error.

(a) Harmless Error. Any error, defect, irregularity of variance which does not affect substantial rights shall be disregarded.

(b) Plain Error. Plain errors or defects affecting substantial rights may be noticed although they were not brought to the attention of the court.

18 U. S. C. A. §1341. Frauds and swindles.

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both. June 25, 1948, c. 645, 62 Stat. 763, amended May 24, 1949, c. 139 §34, 63 Stat. 94.

15 U. S. C. §77q. Fraudulent interstate transactions

(a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communica-

tion in interstate commerce or by the use of the mails, directly or indirectly—

(1) To employ any device, scheme, or artifice to defraud, or

18 U. S. C. A. §371. Conspiracy to commit offense or to defraud United States

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.

If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor. June 25, 1948, c. 645, 62 Stat. 701.

Exhibit 844.

No. 844 which was a so-called black brochure issued October, 1958, which contains the following language on page 5:

> "We cannot legally make specific guarantees in connection with any of the trust deeds sold to our customers. However, it is our policy to repurchase and/or replace any defaulted trust deeds with a trust deed in good standing, when requested by our customers to do so. This is done entirely on a best efforts basis, but to date we have never had a customer of our approved trust deeds sustain a loss nor has any such customer failed to receive his full 10% earnings.

Exhibit 1670.

No. 1670 is a blue brochure issued July, 1959 which contains the following language on page 2 of the brochure at the bottom of the page:

> NOTE: "While this brochure presents the most important points in trust deed investments, it obviously cannot and does not cover the entire subject. We act only as principal, and not as agent. Because no one can actually predict the future, everything that the company does is entirely on a best efforts basis. We do not either expressly or by implication guarantee that any customer will not lose on his investment, nor do we undertake or guarantee to protect any customer from loss. However, since the inception of this company, no customer of our approved trust deeds has ever sustained a loss, nor has any such customer ever failed to receive his full 10% earnings on trust deeds held for at least six months. We do not "pay interest." All 10% earnings which accrue to a customer come to him from the trust deed(s) which he purchases."

No. 1073 is a blue brochure issued February, 1960 which contains the same language as No. 1670.

No. 1674 is a blue brochure issued May, 1960 which contains the same language as No. 1670.

United States Constitution.

Amendment [V]

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Amendment [XIV] Section 1.

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL and OLIVER J. FARRELL,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF OF APPELLANT OLIVER J. FARRELL.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

CASES

STATUTES

No. 18241

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OPENING BRIEF OF APPELLANT OLIVER J. FARRELL.

Statement of the Pleadings.

By Indictment No. 30341, which superseded Indictment No. 25960, Appellants David Farrell, Oliver J. Farrell along with Stanley C. Marks were charged in Counts 1 through 17 of violation of Section 17(2)(1) of the Securities Act of 1933, 15 U. S. Code Section 77q(2)(1), which provides as follows:

> It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly to employ any device, scheme, or artifice to defraud.

They were further charged in Counts 18 through 33 with Mail Fraud in violation of 18 U. S. Code Section 1341, which provides as follows:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000.00 or imprisoned not more than five years, or both.

In Count 34 they were charged with Conspiracy in violation of 18 U. S. Code Section 371, which provides as follows:

> If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or

more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000.00 or imprisoned not more than five years, or both.

[Clk. Tr. pp. 119-193.]

Statement of the Case.

Trial by jury was had, following the close of the Government's case, the Government moved to dismiss Counts 3 and 33, which motion was granted. [Clk. Tr. p. 449.] Each defendant put on a defense, whereupon the jury was instructed, and following deliberation returned the following verdicts:

Stanley C. Marks was found Not Guilty as to all counts [Clk. Tr. p. 512-A]; and Appellants David Farrell and Oliver J. Farrell were each found Guilty on all counts. [Clk. Tr. pp. 505-512.]

Appellant Oliver J. Farrell was sentenced to 2 years imprisonment and fined the sum of $2,000.00 on each of Counts 1, 2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16 and 17 (the Securities Act Counts), the prison terms to run concurrently and making a total fine of $32,000.00.

He was sentenced to 2 years imprisonment and fined the sum of $1,000.00 on each of Counts 18 through 32 (the Mail Fraud counts), the prison terms to run concurrently and making a total fine of $15,000.00.

On the Conspiracy count 34 he was sentenced to 2 years imprisonment and fined the sum of $5,000.00.

The sentences under the Mail Fraud counts were to run concurrent with the Securities Act counts; Count

34 was to run concurrent with the Securities Act counts and consecutive with the Mail Fraud counts, making a total of four years imprisonment and a total fine of $52,000.00. [Clk. Tr. p. 554.]

Notice of Appeal was filed [Clk. Tr. p. 562] and the matter is now before this court, which has jurisdiction to review the judgment of conviction as it arises from alleged violations of the Federal law as set forth in the above-designated sections of the United States Code.

Statement of Facts.

Appellant Oliver J. Farrell hereby adopts the statement of facts as stated in the Opening Brief of Appellant David Farrell, which is being filed concurrently herewith. In addition, reference is made to the facts stated in the opinion of *Securities and Exchange Commission v. Los Angeles Trust Deed and Mortgage Exchange, et al.,* 285 F. 2d 162, which covered the same subject matter in a civil proceeding against the same appellants as is presented in the instant criminal proceeding.

Reference to Exhibits.

Over 2,000 documents were introduced into evidence at the trial and would be too extensive to present as part of this brief. Counsel has conferred with Government counsel on this matter and have agreed that the Government counsel will submit a complete exhibit register to this Honorable Court covering all of the exhibits in this case.

ASSIGNMENTS OF ERROR AND ARGUMENTS.

Appellant Oliver J. Farrell hereby adopts each and every assignment of error and argument presented in the Opening Brief of David Farrell, which is being filed concurrently herewith. In addition, he presents the following assignment of error and argument solely on his own behalf:

The Evidence Is Insufficient on All Counts as a Matter of Law to Sustain the Judgment of Conviction on All Counts.

In the prosecution of this case the government presented an extremely thorough case establishing how the Los Angeles Trust Deed and Mortgage Exchange had engaged in a course of conduct which violated the Securities Act of 1933 and engaged in Mail Fraud. The evidence was directed primarily against the defendant David Farrell who ran the company and directed all of its policies.

In order to fully appreciate the lack of evidence against Oliver J. Farrell in all of the counts on which he was convicted it must be borne in mind that this case was the subject of an intense investigation, the Securities & Exchange Commission having had a receiver running the business since June 8, 1960 and acquired complete access to all of the company's documents and records. It can be stated with substantial certainty that any and all possible evidence which could have been presented against Oliver J. Farrell was produced at the trial, so the Government has actually presented the strongest case it could against him. This lack of evidence sufficient to convict can be illustrated by an

analysis of the testimony of the key witnesses, both prosecution and defense, which clearly illustrated the limited role played by Oliver J. Farrell in the company's activities.

Thomas Wolfe, Jr., assistant to the president, David Farrell, was produced as a government witness, and testified in detail as to L.A.T.D. & M.E.'s activities, as well as those of related corporations. All of the corporations involved were solely owned by David Farrell. David Farrell gave him instructions to create a bank-like atmosphere [Rep. Tr. p. 157] and he alone purchased the trust deeds on unimproved property and prepared the information concerning them. [Rep. Tr. pp. 163, 169, 227.] The advertising firm, Prestige Incorporated, which was owned and controlled by David Farrell, prepared the printed literature which was sent out by the company. [Rep. Tr. pp. 167-168, 334-335.]

Upon Mr. Wolfe first assuming his duties David Farrell did the editing of the letters to the customers. [Rep. Tr. p. 169] and throughout Mr. Wolfe's tenure gave instructions regarding choice of terminology to be used. [Rep. Tr. pp. 196-197.]

Wolfe at pages 159 and 160 described the very limited function of Oliver J. Farrell as heading up the sales organization, conducting sales conferences, making sales meeting speeches, preparing sales literature and breaking in new salesmen.

Albert R. Durham, Director of Trust Deed Selection for the company testified at great length about the company's activities and never once mentioned having any dealings with Oliver J. Farrell. [Rep. Tr. pp. 710-999.]

Monroe R. Stark, a salesman for the company, who was also called as a government witness, testified at great length as to the operation of the sales department, with Oliver J. Farrell in charge. In all of his testimony the only item which even remotely hinted at misrepresentation was the sales "pitch" to properly create the impression to customers that this market place for selling trust deeds would be helpful in liquidating 10% earning accounts. [Rep. Tr. p. 541.]

The only other transaction which could be strained as evidence against Oliver J. Farrell was the fact that he instructed the salesmen not to volunteer the fact of the pending civil litigation with the S. E. C., and if specifically asked to inform the customer that there was no basis for any fraud or insolvency charges. [Rep. Tr. p. 563.]

At pages 683 to 685 of the Reporter's Transcript Mr. Stark testified that Oliver J. Farrell was very strict about the salesman following the language of the company brochure in the sales presentation; that they were not authorized to change the language in the brochure; and that the salesmen could use any selling techniques as long as they did not conflict with the brochure.

As previously stated, the evidence in the record established that David Farrell solely was responsible for preparation of the brochures.

Oliver J. Farrell took the stand in his own defense. After L.A.T.D. & M.E. had already been in existence he joined the firm in the fall of 1955 being hired by David Farrell, eventually in 1957 becoming sales manager of the company. His sales material, which he distributed to the salesmen, was taken from a publica-

tion by Prentice-Hall Publishers entitled Miracle Sales Guide. His explanation of the matters brought out in the testimony of Mr. Stark was as follows:

"Q. Why did you instruct salesmen to explain the Los Angeles Trust Deed & Mortgage Exchange civil litigation with Securities and Exchange Commission only if a customer would ask about it, a prospective customer? A. There had been quite a few inflammatory articles in the newspapers concerning the SEC's charges, and I felt from time to time most big businesses, and in fact most businessmen, do have civil litigation with bureaus or government or agencies. I felt that we should put our best foot forward at all times and not invite people's attention to a civil suit, which I felt would be resolved to our satisfaction in a very short period of time.

I also felt that most of our prospective customers, if not all of them, were already aware of the civil litigation because of the newspaper articles, and also commentaries on television and radio, and it was unnecessary to invite their attention to it. Normally, they would ask us about it.

Q. Were you aware that a receiver would take control of Los Angeles Trust Deed & Mortgage Exchange on June 8, 1960? A. No, sir.

Q. Why did you think that?

The Court: I don't follow your question.

Q. (By Mr. Holder): On what basis did you have that opinion? A. The attorneys for the company, Morgan Cuthbertson and Paul J. Foley, explained to me that this action was similar to

that which had transpired a year or a year and a half previously; that the SEC had obtained a similar injunction at that time and the court had ordered a receiver in then. However, the attorneys were able to have that action appealed and stayed, and on the remand of the case they stated that they felt that they would have the same success with the appellate court, that they would successfully have the lower court's orders reversed.

Q. Why didn't you stop selling trust deeds after May 20, 1960? A. Well, sales were more important then than ever before, with the bad publicity that we had in the papers. On instructions from the attorneys and from David Farrell I encouraged the sales department to roll up their sleeves and work even harder to bring in sales. I felt that it would be an act of disloyalty to walk out on the company because it was having some civil problems.

Q. Do you know personally of any customer of Los Angeles Trust Deed & Mortgage Exchange who sustained a loss prior to June 8, 1960? A. No, sir, not one." [Rep. Tr. p. 3106, line 21, to p. 3108, line 18.]

Under intensive cross-examination the well-prepared Government was unable to establish any evidence that Oliver J. Farrell had engaged in any transactions with intent to defraud or that he had any control over the company or that he had any knowledge that any fraud was being practiced by the company. His testimony that he instructed the salesman to follow the language in the brochure was not refuted. [Rep. Tr. p. 3122.] David

Farrell supplied the information that there was to be a trust fund for investors' money [Rep. Tr. p. 3134], that David Farrell owned Mortgage Insurance Company of America [Rep. Tr. p. 3138], Oliver J. Farrell denied any knowledge of all of the various corporations created by David Farrell and also denied knowledge of any side participation agreements which David Farrell engaged in. [Rep. Tr. pp. 3162-3163.] With over 2000 documents introduced by the Government none were produced to refute this testimony of Oliver J. Farrell.

The Government grasped at straws in attempting to tie in Oliver J. Farrell with the side participation agreements of David Farrell. With millions of dollars and thousands of lots involved in the side participation agreements, of which David Farrell received 50% for his own benefit, the government tried to make Oliver J. Farrell a participant therein by showing that he received the grand total of 4 lots of Embarcadero property. These 4 low value lots were subject to a $5,000.00 mortgage which Oliver J. Farrell assumed. In addition he agreed to develop *at his own expense* a horse stable and riding academy in order to enhance the value of the Embarcadero tract. [Rep. Tr. pp. 3156-3158.] This undisputed evidence clearly showed that he was supplying services and money for the above 4 lots and was not receiving them as a participant in a fraudulent scheme.

Co-defendant Stanley C. Marks testified in his own behalf. Not one transaction involving Oliver J. Farrell was involved in his testimony.

Morgan Cuthbertson, formerly a staff attorney for the Securities & Exchange Commission for 13 years in Los Angeles, related how he was hired by David Farrell

to advise the firm in its dealings with S.E.C. This critical witness brought out that he dealt with David Farrell exclusively in his relationship as attorney for L.A.T.D. & M.E. and that David Farrell prepared the brochures. Nowhere in his testimony is there any suggestion that Oliver J. Farrell had any voice in directing the company's policy.

Thomas J. Graham, the appraiser employed by L.A.T.D. & M.E. did not even mention Oliver J. Farrell in his testimony.

David Farrell testified in his own behalf, stating that he first entered the mortgage business in 1952 [Rep. Tr. p. 3703], organizing L.A.T.D. & M.E. in 1954. [Rep. Tr. p. 3705.] He testified at length as to how he organized and ran the company, made all decisions on policy, organized various side corporations which he solely controlled, and solely entered into numerous side participation agreements to acquire trust deeds for L.A.T.D. & M.E.

His role in the proceedings is best illustrated by the following testimony.

> "Q. Who primarily made the policy decisions of the Los Angeles Trust Deed & Mortgage Exchange? A. I did.
>
> Q. Did Mr. O. J. Farrell make those decisions? A. No, he did not make the decisions." [Rep. Tr. p. 4040, lines 20-24.]
>
> Q. If you were to characterize the company, would you characterize it as a one-man company under your direction? A. I would characterize it as being completely under my direction, yes, sir." [Rep. Tr. p. 4041, lines 2-5.]

His testimony, at pages 4225-4226, verified that Oliver J. Farrell in return for the 4 Embarcadero lots did establish stables of high quality, the horses appearing in many horse shows under the name of Embarcadero Stables throughout California.

From the record there is no question that David Farrell completely controlled the 10% Secured Earnings program of L.A.T.D. & M.E., with nobody within the company framework in a position to challenge the manner in which he ran the company. This is especially true when he clearly let it be known to all persons that his activities were being carried out pursuant to the advice of an attorney who had spent 13 years with the S.E.C. Rather than go through all of the various arguments and justifications for the policy of the company, reference is made to *Declaration of David Farrell,* set forth in pages 228-235 of the Clerk's Transcript. It is difficult to conceive of any employee challenging these persuasive sounding arguments.

Appellant, Oliver J. Farrell, respectfully urges that the evidence is insufficient to impute to him any knowledge of any fraudulent scheme or any intent to defraud. His role as only sales manager in this highly departmentalized operation is thoroughly demonstrated throughout the record, as is the fact that David Farrell made all of the policy decisions, directed the operations of the company and caused huge profits to be made by his solely owned corporations which dealt with L.A.T.D. & M.E. True, Oliver J. Farrell is the brother of David Farrell, and that fact undoubtedly had great influence on the jury in arriving at their verdicts to convict him. This is especially true when this Honorable Court con-

siders the background of the prejudicial newspaper publicity and public hysteria during the course of the trial. The extremely fair trial judge constantly admonished the jury not to read the newspaper accounts of the trial and made every reasonable attempt to conduct the trial free from outside pressure on the jury. From the foregoing examination of the record, however, it appears clear that Oliver J. Farrell's activities are as reasonably consistent with innocence as with guilt on all counts, so the convictions cannot be sustained on the evidence introduced against him.

> "The verdict in a criminal case is sustained only when there is 'relevant evidence from which the jury could properly find or infer, beyond a reasonable doubt,' that the accused is guilty. *Mortenson v. U. S.*, 322 U. S. 369, 64 S. Ct. 1037, 88 L. Ed. 1331."
>
> *American Tobacco Co. v. United States* (1946), 328 U. S. 781, 66 S. Ct. 1125, 90 L. Ed. 1575.

In *Gravatt v. United States* (1960, 10 Cir.), 260 F. 2d 498, the court held:

> "It is, of course, Hornbook law that in criminal cases, the Government must prove the defendant guilty beyond a reasonable doubt, and if the undisputed evidence is as consistent with innocence as with guilt, the Government has failed to make a case to go to the jury."

In accord:

> *Leslie v. United States* (10 Cir.), 43 F. 2d 288;
> *Moore v. United States* (10 Cir.), 56 F. 2d 794;
> *McClintock v. United States* (10 Cir.), 60 F. 2d 839;

Patterson v. United States (10 Cir.), 62 F. 2d 968;

Parnell v. United States (10 Cir.), 64 F. 2d 324;

Gargotta v. United States (8 Cir.), 77 F. 2d 977.

Where guilt in prosecution for using mails to defraud, violation of Securities Act, and conspiracy rests upon circumstantial evidence, government has burden of proving its case not only beyond a reasonable doubt, but to exclusion of every reasonable hypothesis of innocence. *Beckman v. United States* (1938, 5 Cir.), 96 F. 2d 15.

Directing the Court's attention to Count 34, the Conspiracy count, again there is nothing in the record to establish that Oliver J. Farrell joined a conspiracy, either in the way of direct or circumstantial evidence. Conjecture and speculation cannot take the place of evidence.

In *Ingram v. United States,* 360 U. S. 672, 79 S. Ct. 1314, 3 L. Ed. 2d 1503, in setting aside the conviction the court relied upon and at page 680 quoted the language of *Direct Sales Co. v. United States,* 319 U. S. 703, 63 S. Ct. 1265, 87 L. Ed. 1674, as follows:

> "Without knowledge the intent cannot exist. . . . Furthermore, to establish the intent, the evidence of knowledge must be clear, not equivocal. . . . This, because charges of conspiracy are not to be made out by piling inference upon inference, thus fashioning . . . a dragnet to draw in all substantive crimes."

The *Direct Sales Co.* case, *supra,* also considered the effect of holding in *United States v. Falcone,* 311 U. S. 205, 61 S. Ct. 204, 85 L. Ed. 128, and at page 709 adopted the interpretation:

> "that one does not become a party to a conspiracy by aiding and abetting it, through sales of supplies or otherwise, unless he knows of the conspiracy; and the inference of such knowledge cannot be drawn merely from knowledge that the buyer will use the goods illegally."

Conclusion.

Wherefore, in view of the foregoing, Appellant Oliver J. Farrell respectfully requests that the Judgment of viction as to all 32 Counts be reversed, and that the charges against him be ordered dismissed as to all counts.

Respectfully submitted,

GOULD & ARONSON and
PAUL AUGUSTINE, JR.,
Attorneys for Appellant
Oliver J. Farrell.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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Attorney for Appellant
Oliver J. Farrell.

No. 18241

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APPELLEE'S BRIEF.

(Appendices Under Separate Cover)

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TOPICAL INDEX

PAGE

VI.

VII.

TABLE OF AUTHORITIES CITED

CASES PAGE

PAGE

PAGE

RULES

STATUTES

TEXTBOOK

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL and OLIVER J. FARRELL,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

I.

JURISDICTIONAL STATEMENT.

The appellants David Farrell and Oliver J. Farrell were indicted by the Federal Grand Jury for the Southern District of California, Central Division, on December 20, 1961.[1] The indictment contained thirty-four counts. The first seventeen counts alleged offenses under Section 17(a)(1) of the Securities Act of 1933, 15 U. S. C. 77q(a)(1). The following sixteen counts alleged offenses under the Mail Fraud Statute, 18 U. S. C. 1341. The last count alleged a conspiracy (18 U. S. C. 371) to violate Section 17(a)(1) of the

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[1]This indictment, No. 30341-CD, superseded an earlier indictment, No. 29560-CD, returned on March 8, 1961 [C. T. 2, 119]. On March 6, 1962, prior to the commencement of trial on No. 30341-CD, the superseded indictment, No. 29560-CD, was dismissed on the court's own motion [C. T. 113].

Securities Act and the Mail Fraud Statute [C. T. 119].[2]

The appellants were arraigned, entered pleas of not guilty, and following a twenty-seven day trial by jury they were convicted on all 32 counts that went to the jury[3] [C. T. 505, 509]. A third defendant, Stanley C. Marks, was acquitted on all 32 counts [C. T. 512A].

The appellant David Farrell was sentenced on the sixteen securities counts to a cumulative period of five years imprisonment and fined a total of $64,000. He was sentenced on the fifteen mail fraud counts to a cumulative period of five years imprisonment and fined a total of $15,000, the sentences of imprisonment to run concurrently with the sentences imposed under the securities counts. He was also sentenced to five years imprisonment on the conspiracy count and fined $7,500, with the prison sentence to run concurrently with the sentences imposed under the securities counts, and consecutively with the sentences under the mail fraud counts. Thus, David Farrell was sentenced to a total of ten years imprisonment and fined a total of $86,500 [C. T. 554].

The appellant Oliver J. Farrell was similarly sentenced to concurrent and consecutive terms of imprisonment totaling four years and fined a total of $52,000 [C. T. 554].

The sentences imposed by the court, as to both appellants, were made subject to the provisions of 18 U. S. C. 4208(a)(2), the court fixing the aforemen-

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[2]C. T. refers to Clerk's Transcript of Record.

[3]Two counts were dismissed by the government during the course of trial [R. T. 3406].

tioned maximum periods of imprisonment to be served by the appellants David Farrell and Oliver J. Farrell at ten and four years respectively, and specifying that appellants shall become eligible for parole at such time as the Board of Parole may determine [C. T. 554].

The jurisdiction of the district court rests on Sections 20(b) and 22(a) of the Securities Act of 1933, 15 U. S. C. 77t(b) and 77v(a), and 18 U. S. C. 3231. This Court has jurisdiction to review the judgments of the district court pursuant to 28 U. S. C. 1291 and 1294.

II.

STATUTES INVOLVED.

The Indictment was brought under three different statutes, which provide in pertinent part, as follows:

15 U. S. C. 77q(a)(1), (Sec. 17(a)(1) of the Securities Act) *re*: counts one, two, and four through seventeen, inclusive:[4]

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commece or by the use of the mails, directly or indirectly—
>
> "(1) to employ any device, scheme, or artifice to defraud . . ."

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[4]The penalty provision relating to Section 77q(a)(1) may be found in 15 U. S. C. 77x, which provides, in pertinent part as follows:

> "Any person who willfully violates any of the provisions of this subchapter, . . . shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both."

18 U. S. C. 1341 (Mail Fraud Statute) *re*: counts eighteen through thirty-two, inclusive:

> "Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, . . . for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both."

18 U. S. C. 371 (conspiracy statute):

> "If two or more persons conspire either to commit any offense against the United States, . . . and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both. . . ."

III.

STATEMENT OF THE CASE.

A. Summary of Indictment.

The indictment is in thirty-four counts. The first, or "base count," alleges a scheme to defraud in the sale of securities by Los Angeles Trust Deed & Mortgage Exchange under its Secured 10% Earnings Program, in violation of Section 17(a)(1) of the Securities Act of 1933 (Securities Act), 15 U. S. C. 77q (a)(1). The "base count" describes the scheme to defraud in detail. The scheme is set forth in the Statement of Facts, *infra* page 9. The next sixteen counts, each of which also alleges a separate violation of Section 17(a)(1) of the Securities Act, incorporate by reference the allegations made in the "base count." These seventeen counts are the "securities counts."

The following sixteen counts of the indictment, also by reference to the "base count", incorporate the statement of the scheme to defraud as set forth in the "base count," except that the instruments through which the scheme was accomplished are not described as securities. These are the mail fraud counts, alleged in the language of the Mail Fraud Statute, 18 U. S. C. 1341.

The thirty-fourth, and last count, alleges a conspiracy to violate the Securities Act and the Mail Fraud Statute, in violation of 18 U. S. C. 371. The conspiracy count also alleges and incorporates by reference the allegations made in the "base count," as constituting elements of the conspiracy, and sets forth numerous other overt acts accomplished in furtherance of the conspiracy.

B. Pre-Trial and Trial Proceedings.

Extensive pre-trial proceedings were conducted, commencing on January 5, 1962, under the guidance of United States District Judge John F. Kilkenny [C. T. 194]. During these proceedings, appellants were arraigned, entered pleas of not guilty, and presented many motions to the court, the rulings on which are not contested on this appeal [C. T. 212; 362; 413].

The government marked for identification and exhibited to appellants some two thousand numbered exhibits prior to the trial, many of which contained numerous attachments. More than one thousand of these exhibits were stipulated to as being genuine and authentic [C. T. 375-410].

On March 6, 1962, the taking of testimony commenced before Judge Kilkenny, and continued for twenty-seven trial days, concluding on April 13, 1962, with the court's instructions and submission of the case to the jury [C. T. 418-464]. On April 16, 1962, the jury returned verdicts of guilty as to both appellants, on each of the 32 counts submitted to them [C. T. 505-512D].

On April 20, 1962, counsel for appellant Oliver J. Farrell filed a motion for judgment of acquittal or, in the alternative, for new trial [C. T. 542]. Counsel for appellant David Farrell filed similar motions on April 23, 1962 [C. T. 547]. Numerous supplemental memoranda, declarations and statements were filed on behalf of appellants prior to the date of hearing [C. T. 519-521; 522-524, 525-526; 527-529; 530-541]. All motions were opposed in the government's written opposition [C. T. 550]. On May 14, 1962, following argu-

ment on the motions, the court denied each of them [C. T. 553; R. T. 4348-4381].[5]

On May 14, 1962, Judge Kilkenny sentenced appellants [C. T. 554; R. T. 4382-4397]. Both appellants gave oral notice of appeal at the time of sentencing [R. T. 4393; 4398], and subsequently filed, in timely fashion, their written notices of appeal [C. T. 560; 562].

On June 12 and June 18, 1962, appellants David Farrell and Oliver J. Farrell, respectively, filed their "Designation of Contents Of Record On Appeal"[6] [C. T. 564, 568], which were followed on June 28, 1962, by Appellee's Counter Designation [C. T. 573].

Appellants have filed separate opening briefs on this appeal. Appellee has consolidated its response in this Brief.

IV.

INTRODUCTION TO STATEMENT OF FACTS.

The appellants concede that the evidence submitted to the jury was sufficient to establish the existence of a scheme and conspiracy to defraud. Indeed, the appellant Oliver J. Farrell, with extraordinary candor, admits that "the government presented an extremely thorough case, establishing how the Los Angeles Trust Deed & Mortgage Exchange had engaged in a course of conduct which violated the Securities Act of 1933 and engaged in Mail Fraud" [Brief, OJF p. 5]. This

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[5]"R. T."—refers to Reporter's Transcript of Proceedings.

[6]Neither of appellants' designations contained ". . . a concise statement of the points on which he intends to rely. . . ." as required by Rule 17(c) of the Rules of the United States Court of Appeals for the Ninth Circuit.

appellant then proceeds to cast all blame on David Farrell, his brother and co-appellant, noting, for example, the manner in which "David Farrell made all of the policy decisions, directed the operations of the company and caused huge profits to be made by his solely owned corporations which dealt with LATD&ME." [Brief, OJF p. 12].

With somewhat less candor, the brief for David Farrell admits [Brief, DF pp. 13-14] that "appellant does not assert insufficiency of the evidence simply in recognition of the limited role a reviewing court has in such a situation . . ."

Neither appellant has attempted to furnish this court with a summary of the facts as shown by the record. The reason for this omission is evident. The evidence of a deliberately planned and long-continued scheme executed by appellants is massive, documented, and uncontradicted as to any significant element.

The government believes, however, that a statement of facts will be of assistance to the court in the disposition of this appeal. Before setting forth its summary of the scheme to defraud, the government wishes to note that the thin and tenuous nature of the minor assignments of error which appellants have dredged up from the extensive trial record constitutes a definite, if unintended, tribute to the firm, dispassionate and truly judicial manner in which the court below conducted the trial. In this case, the following observation of Chief Judge Lumbard in *United States v. Aviles,* 2d Cir. 1960, 274 F. 2d 179, 194, seems applicable, "the trial judge was eminently fair [to appellants] to the point of being overgenerous."

V.

STATEMENT OF FACTS.

Scope of Scheme to Defraud.

Appellant David Farrell originated the concept of the Secured 10% Earnings Program, placing it into operation in approximately December of 1957, through the corporate entity LATD&ME [R. T. 115; GX 1645]. Though David Farrell controlled and directed the basic policy of LATD&ME, and generally "ran the company" [R. T. 162], appellant Oliver J. Farrell, as vice-president and sales manager, was directly responsible for the method, by which the plan was presented to investors [R. T. 159].

From a modest beginning in December of 1957, LATD&ME, during its two and one-half year existence had entrusted to it by some 9,000 investors approximately $40,000,000.[7] This enormous growth was engendered by a well organized, highly coordinated sales organization maintained throughout California;[8] use of a saturation advertising technique encompassing the placing into the mails of countless thousands of brochures and other selling literature [GX 843; 1150; 1401; 1666; 1667; 1668; 1669; 1670; 1672; 1674] as well as the use of the mass communication media (radio, TV, newspapers) to sing loud the praises of Se-

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[7]As of March, 1958, LATD&ME had entrusted to it more than $5,000,000 of investors' funds; by August, 1959, total dollar volume had grown to more than $20,000,000; when the receiver took over on June 8, 1960, over 9,000 investors had deposited about $40,000,000 under the Secured 10% Earnings Program [GX 649; 846; 1152; 1651].

[8]See *infra*—Role of Oliver J. Farrell in the Scheme to Defraud.

cured 10% Earnings [GX 648; 649; 850; 851; 852; 853; 854; 1151; 1152].

The brochures, other selling literature and advertisements so widely circulated, were designed, without exception, to convey the message that LATD&ME was a long-established, stable and sound financial institution of unquestioned standing and integrity in the financial community, to which all investors, whatever their financial status, could entrust their savings with implicit confidence [GX 843; 1150; 1401; 1666; 1667; 1668; 1669; 1670; 1672; 1674]. This sales presentation was eminently successful, and succeeded in conditioning the minds of investors, residing throughout the United States and several foreign countries, to believe that LATD&ME had developed a new and distinctive plan which assured safety and liquidity of investment, while at the same time furnishing earnings of 10% compounded monthly.[9]

Origin of the Secured 10% Earnings Program.

The appellant David Farrell first started LATD&ME with some five or six salesmen operating out of a small office in Los Angeles, California [R. T. 507]. Initially, its business consisted solely of securing options to purchase trust deeds from individuals, and then attempting to sell these trust deeds at a price in excess of the option price. These, of course, were riskless transactions. If no buyer appeared the option was dropped [R. T. 503-506.] LATD&ME offered no guaranty of the quality of any trust deed and made no undertaking

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[9]See *infra*—"Method of Presentation of Secured 10% Earnings Program to Investors."

to service the trust deed on behalf of the buyer [R. T. 507].

In late 1957 the Secured 10% Earnings Program, as devised by the "fertile" brain of David Farrell, was brought into existence. Its beginning, on a modest scale, was announced through an internal staff bulletin dated December 10, 1957, stating: "Effective immediately a new program shall be promulgated by the Exchange called the 'Secured 10% Earnings Program' . . ." [R. T. 507; GX 1645]. As described by the executive assistant to appellant David Farrell, under the new plan, LATD&ME "purchased trust deeds at discounts from individuals, builders, developers, and sold them to the public on a Secured 10% Earnings Plan that included the assignment of the trust deed and note, and the *complete line of services* from the processing of papers to the vault storage of papers, to the collection and possible repurchase of the trust deed, through to the recording of payments from trustors, home owners, to the liquidation of trust deeds. In other words, *the customer could rely on the company for all phases of handling from the purchase to the sale of the trust deeds.*" (Emphasis added.) [R. T. 114,; also see R. T. 508-509].

Corporate Organizations Involved.

LATD&ME, a California corporation, 87% of whose stock was owned by David Farrell was the center and hub of the Secured 10% Earnings Program.[10] David

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[10]LATD&ME maintained branch or "franchise" offices in San Francisco, Oakland, San Diego, Santa Barbara, Beverly Hills, San Fernando Valley, Pasadena and Orange County, California [R. T. 156, 288]. Contrary to a pretentious letterhead, LATD&-

Farrell was chairman of the board of directors and president of LATD&ME [R. T. 162]. His brother Oliver J. Farrell was a director, vice-president and secretary-treasurer [R. T. 3111-3112]. Thomas Wolfe, Jr. was executive assistant to David Farrell [R. T. 113]. Monroe [Frank] Stark was a vice-president and regional manager of the Northern California branch offices [R. T. 510, 682].

About August, 1959, after the SEC civil suit was underway, LATD&ME "spun-off" its out of state business to TD&MM, a wholly owned subsidiary. TD&MM was a mere department of LATD&ME. An effort was made to establish a separate selling organization in Colorado under the name Colorado Trust Deed & Mortgage Exchange (CTD&ME). This soon became a wholly owned subsidiary of LATD&ME [R. T. 171-173; GX 1653; 1633; 1628].

Although LATD&ME was the center and hub of the Secured 10% Earnings Program,[11] still another organization was superimposed upon the tier of corporations engaged in the administration of the Secured 10% Earnings Program. This was Trust Deed & Mortgage Exchange (TD&ME), wholly owned by David Farrell and his wife [R. T. 151-152]. TD&ME had no employees, performed no useful services, contributed nothing of value to the Secured 10% Earnings Program, but as "national coordinator" of the Secured

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ME did not maintain offices in all "principal cities" [of the United States] [GX 1651].

[11]All the accounting records for all the offices were kept in Los Angeles, and confirmations mailed to customers, trust deed notes, trust deeds, etc., newspaper advertising, brochures and letters, likewise all originated in Los Angeles [R. T. 158, 206, 211; 512-513].

10% Earnings Program received 10% of the gross profits from LATD&ME's business with investors [R. T. 151-152]. Through TD&ME between July, 1957, and March, 1960, David Farrell channeled $542,960 *of funds received from investors* into his own bank accounts and individual enterprises [GX 7807; 7809; R. T. 2613-2616].

During about the same period of time (March, 1958-June, 1960), LATD&ME disbursed to Prestige, Inc., a corporation wholly owned by David Farrell [R. T. 167-168], $599,978 ostensibly for advertising expenses [GX 7805; R. T. 2611-2612].

In addition David Farrell[12] withdrew through Mortgage Insurance Corporation of America (MICA), a Colorado corporation, $293,000.[13] MICA's only other customer was Colorado Trust Deed & Mortgage Exchange, also owned by David Farrell and his wife. Though David Farrell claimed MICA was formed to protect LATD&ME investors, MICA had no assets, liabilities, or dealings of any kind except as indicated above [R. T. 4180-4184 also see R. T. 311-321].

Appellant David Farrell also received $239,000 from LATD&ME as his salary from January, 1958, to June of 1960 [GX 7802; R. T. 2609]. The appellant Oliver J. Farrell received as salary during the same period $251,629 [R. T. 2608-2609; GX 7801].

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[12]David Farrell and his wife owned all of MICA's capital stock [R. T. 4179].

[13]$100,000 "as an inducement" to have MICA insure trust deeds of LATD&ME in California, and $193,000 to MICA allegedly for the insurance [R. T. 4180, 4181].

Description of Secured 10% Earnings Program.

The Secured 10% Earnings Program, as devised and refined by appellants, was based on the concept of acquiring for the inventory of LATD&ME discounted second trust deed or mortgage notes and selling them to investors at prices which it was represented would allow secured earnings of 10% per annum, compounded monthly, based on the stated interest rate of the obligation, and the "anticipated term" of the note [R. T. 716-717; GX 2136; 2137; 2138]. Many of the obligations were without fixed maturities, but merely established the principal sum due, and the amount to be paid monthly until the indebtedness was satisfied. These were known as "until paid notes." Another classification of trust deeds carried definite maturities but with such small monthly installments that heavy terminal or "balloon" installments became due at maturity. Others were "interest only" obligations with the entire principal amount due at maturity. Still others were conventional notes, carrying specified interest rates to be amortized over stated periods of time [GX 1901-1932].

While it was represented to investors that the trust deeds were sold to them at prices calculated to "yield" or "earn" 10%, in fact, in most but not all instances, the formula used by LATD&ME in computing the price at which a trust deed was to be introduced into an investor's account resulted in a substantial overcharge [R. T. 797]. As LATD&ME's "director of trust deed selection" testified, "the longer the period of the note, the greater the overcharge to [the investor] . . ." [R. T. 712, 808]. By this he meant that under the formula used by LATD&ME the yield to the in-

vestor would be less than the represented 10% ". . . Sometimes quite a bit less." [R. T. 797-798]. Thus on a ten year $10,000 note, an investor was overcharged $666, while on a $10,000 "until paid" note, the overcharge was $587 [R. T. 802]. Therefore, from the very inception of his account, the investor was misled as to the basis of the price at which the trust deed was confirmed into his account, and as to the fact that the trust deed itself would really "yield" 10%.

"Earnings" on Uninvested Funds Entrusted to LATD&ME—Estimated Liquidation Statements.

The investors under the Secured 10% Earnings Program fell within two classifications. The first were those known as "income investors," who wished to receive a monthly earnings check representing the mathematical computation of 1/12 of 10% per year, or a lesser fixed amount. The second, and more numerous, were "growth investors," who wished to allow their "earnings" to accumulate for "continuous re-investment" [R. T. 114, 115]. At all times, LATD&ME represented that any new account started, or additional deposit made by the twentieth of the month "earned" a "secured" 10% from the first of the month [GX 846].

Each investor received monthly a "Condensed Summary" of his account, referred to as a "liquidation statement" which *purported* to show the status of the account at month's end.[14] [GX 1223; 1270; Appendix D]. This statement was designed to show the amount

[14]The last column of this statement was originally entitled "Estimated Liquidation Value of All Assets in Your Account." Subsequently, the title was changed to read "Estimated Liquidation Value of All Your Assets in Our Possession."

of money the investor would receive if he decided to withdraw his funds from LATD&ME [R. T. 814-815, 821-822; GX 1223]. As to an investor who was actually receiving monthly "earnings" checks, the summary "cash-out" statement[15] merely indicated that his original investment remained intact. The investor, however, was never advised that any uninvested funds in his account were debited each month by an amount equal to 1/12th of 10% of his deposit as a "miscellaneous charge" against the account, thereby reducing, on the internal investors ledger, the investors credit balance and the corresponding liability of LATD&ME [GX 1100; 1115; Appendix B]. The "cash-out" statement sent to each "growth investor" in essence was merely a projection of the anticipated accumulation of "earnings" for the funds deposited, computed arithmetically with a 10% interest increment each month. This estimated projection bore no resemblance to the actual increment or "earnings" from any trust deeds that might have been introduced into the account [R. T. 814, 817]. For example, an investor who deposited $1,000 with LATD&ME on January 20, would receive at month-end a condensed summary showing that his account had grown to $1,008.33, and by the second month-end to $1,016.73, and by year-end to $1,104.71. The condensed summary translated into specific terms, for each investor, the growth tables set forth in LATD&ME's brochures [GX 842, 843, 844, 1668, 1670; 1674; Appendices C and D].

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[15]All investors were conditioned to regard the "liquidation value" as the immediate cash value of their accounts which they could realize at any time [R. T. 614; 821-822; GX 1403]. That such was actually believed by LATD&ME's customers, see *infra* "Presentation of Secured 10% Earnings Program to Investors."

The "liquidation" statement was sent to each investor regardless of whether his account had ever been invested in a trust deed, and regardless of whether the account contained nothing except delinquent or defaulted trust deeds [R. T. 903-904]. The "liquidation values" shown on the condensed summaries were intended for investors alone. They were designed to assure investors that through LATD&ME's investment plan their savings at all times were accumulating at a safe and steady rate of 10% compounded monthly, or, if the investor was receiving his 10% "earnings" each month, his *full* principal investment was remaining untouched.

There was no correlation whatever between the *actual liquidation value* of the account and the amount shown on the monthly summary, or between the monthly statement sent to investors and the *true internal records* maintained by LATD&ME reflecting the status of investors' accounts [R. T. 814]. These would be reconciled by arbitrary entries made at the time the investor closed his account [R. T. 814-815]. In addition, these "liquidation values" were not reflected in LATD&ME's general ledger [R. T. 2379].

LATD&ME commenced to disburse monthly "earnings" checks to investors who had "income accounts" prior to the time any trust deeds were confirmed to their accounts by LATD&ME [R. T. 1056; 1989]. When such investors withdrew their investments, before trust deeds had been held in their accounts six months or more, LATD&ME deducted the aggregate of the monthly earning checks from the amount of the principal investment, or on "growth accounts" merely returned the principal so that the investor received no

"earnings" whatever [R. T. 486-494; 2200; 3291-3298; 3382]. The deceptive and misleading manner in which LATD&ME accomplished this maneuver is best illustrated by the fact that an attorney, called as a witness by appellants to testify as to his satisfaction with his investment with LATD&ME, admitted that he had not realized, until the moment of his cross-examination, that he had received from LATD&ME only his principal, without any "earnings" thereon [R. T. 3287, 3291-3298].

The appellants' entire lack of good faith in sending the liquidation statements to investors is shown by David Farrell's instructions to the company's "independent" accountant to disregard the "estimated liquidation statement" as meaningless [R. T. 2380], while, at the same time, LATD&ME was mailing notices to all investors advising them that their *taxable income* on "earnings" from their accounts should be calculated by adding up the accruals shown on the twelve monthly summaries which they had received [GX 1403]. Thus, investors were deceived as to the status of their accounts with LATD&ME, while being counselled to regard as taxable income the fictitious accruals shown in the "liquidation statements."

Liquidation of Investors' Accounts and Overstatement of Inventory Account.

When an investor liquidated his account under the Secured 10% Earnings Program, the trust deed[s] in the investor's account would be valued arbitrarily in order to bring the internal ledger account balance into agreement with the liquidation statement balance [R. T. 815]. For example, if an investor deposited $1,000 and LATD&ME sold him a trust deed for $1,400, a debit

balance of $400 was created in the investor's ledger account. If at the time he closed his account, his liquidation statement or condensed monthly summary showed a credit of $1,100, LATD&ME would repurchase the trust deed for its inventory account at a figure of $1,500 so that the credit balance in his ledger account would be $1,100, or the same as shown in the liquidation statement. This was true regardless of the fact that the original cost to LATD&ME of the trust deed may have been only $800. LATD&ME would then send a check for $1,100 to the investor [R. T. 816]. The effect of the repurchase of the trust deed at $1,500 for inventory would be to overstate inventory by $700, since the repurchase price was even in excess of the retail selling price [R. T. 816-817]. There were numerous instances where trust deeds were taken back into inventory above the face value [R. T. 817].

In other instances, where a liquidation request was received from an investor who had delinquent trust deeds in his account, notwithstanding the delinquency, the investor would be paid the full "liquidation value" of the account, as shown on the liquidation statement, including 10% "earnings" compounded monthly. Of course, this situation could exist only as long as LATD&ME had more money coming in than going out. Obviously, LATD&ME would have to write off the difference between the true value of the delinquent trust deeds brought back into inventory and the "liquidation value" of the account [R. T. 915-916]. This was, quite simply, a scheme under which investors who liquidated their accounts were satisfied at the expense of newer investors who continued to pour their savings into LATD&ME.

Misuse of Trust Funds.

LATD&ME represented at least through January of 1959 that investor funds were ". . . deposited in a separate trust account for customers' money . . ." [GX 842, 1666; R. T. 602-603; 1422; 2187-2188]. The facts were, from the inception of the Secured 10% Earnings Program in December of 1957 funds received by LATD&ME were deposited in general corporate accounts and indiscriminately used as dictated by David Farrell. The funds allegedly in "trust accounts" were used, for example, in carrying debit balances in the accounts of "growth" investors and financing David Farrell's numerous speculations in real estate subdivisions [GX 842; 1056-1065; 1068; 1072; 1073; R. T. 2353-2361; Appendix A].

Lag in Introducing Trust Deeds Into Investors' Accounts.

LATD&ME committed itself to credit the account of each investor monthly or at his option to send him an amount equal to 1/12 of 10% of the amount deposited. This commitment existed regardless of the fact that experience had shown the supply of trust deeds available for introduction into the accounts of investors *often lagged behind the accumulation of new deposits by investors for whom no trust deeds were available.* This delay in introducing trust deeds into investors' accounts became an ever increasing problem as millions of dollars in new deposits were received from investors [R. T. 616-617]. The continuing need to find new trust deeds forced LATD&ME to lower its already inferior investment standards. Accordingly, more and more trust deeds were "secured" by raw unimproved land [R. T. 652].

Substantial amounts of investors' funds remained uninvested even after the completion of "crash programs" designed to improve LATD&ME's balance sheet position. During these "crash programs," trust deeds by the thousands, including delinquent trust deed obligations, were introduced into the accounts of investors in order to create ostensible profits to LATD&ME before presentation to the public of financial statements intended to create an appearance of solvency and stability [R. T. 880-882, 900-903; 2366-2369, 2397; GX 2127].

Method of Manufacturing Trust Deeds for Investors' Accounts.

At the inception of the Secured 10% Earnings Program, at least some of the trust deeds acquired by LATD&ME and introduced into the accounts of investors were secured by finished lots within an approved real estate subdivision, and in some instances by owner occupied homes. However, as investors throughout the nation and abroad deposited their savings with LATD&ME in ever increasing amounts,[16] it became necessary for LATD&ME to arrange for the creation of more and more trust deeds in order to absorb investors' credit balances,[17] and to maintain the fiction that investors'

[16]Investors poured well over a million dollars a month into LATD&ME from late 1958. Over $3,000,000 a month was deposited with LATD&ME during the first five months of 1960 with some $5,266,000 taken in in the month of January alone [GX 846].

[17]For example, even at 10% simple interest, one million dollars of uninvested funds cost LATD&ME $100,000 per year. The seriousness of the firm's financial plight is realized when it is seen that the amount of uninvested credit balances as of October 30, 1958, was $1,216,351; as of June 1, 1959, was $2,468,714; and as of September 25, 1959, was $2,103,426 [R. T. 883; GX 1068; 1072; 1073].

accounts were continuously reinvested to yield a firm, full 10% compounded monthly [R. T. 238, 652, 653].

Appellants met their problem[18] by turning LATD&ME into a medium through which many thousands of trust deeds were created or manufactured against units of raw land situated within projected subdivisions in which David Farrell received "participations" through joint venture agreements or similar arrangements.[19] These trust deeds were created, brought into inventory by LATD&ME, and introduced into the accounts of investors in a wide variety of the most speculative situations[20] [R. T. 386; 713-715; 1739-1740; 2084-2085, 2127-2129].

The trust deeds created against the subdivisions and projected subdivisions[21] carried subordination clauses [GX 1901-1932] under which the trust deeds were to be subordinated to first trust deeds of indeterminable amounts to accommodate the cost of construction of the structure to be erected, and in some instances to cover at least a portion of the cost of "manufacturing" or "finishing" the lots.[22] While in form the trust deeds

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[18]As Oliver J. Farrell wrote in a memo to Frank Stark, May 27, 1959, ". . . we have an ever-increasing problem in getting our customers invested with acceptable Trust Deeds . . ." Farrell then commented on LATD&ME's "severe shortage of suitable small trust deeds to assign to customers" [GX 1634; R. T. 248; 250; also R. T. 616-617; GX 1603; 1621; 1632].

[19]See Appendix A, column entitled "PARTICIPATIONS BY DAVID FARRELL."

[20]See Appendix A, and *infra* "Method of Presentation of Secured 10% Earnings Program to Investors."

[21]Appendix A.

[22]A "manufactured" or "finished" lot is defined as a lot within an approved subdivision where all necessary improvements such as grading, installation of streets, curbing, sewers, and gutters have been completed [R. T. 2093-2095].

so acquired by LATD&ME and introduced into the accounts of its investors were first trust deeds, they were in reality no better than second trust deeds. In some instances they occupied a status even junior to a conventional second trust deed as it was contemplated or a fact that improvement bonds would be created against the subdivision [R. T. 1619, 1622, 1624, 1658; GX 33]. In other situations the trust deeds brought into inventory by LATD&ME were subject to blanket first liens which did not include clauses under which the lien might be removed on a *pro tanto* basis as to individual lots [R. T. 1208-1209].

The funds entrusted to LATD&ME by investors were used in establishing the proposed subdivisions, acquiring the land to be subdivided, and carrying out any engineering and related work that was accomplished in manufacturing and finishing the lots within the subdivision.[23] Typically in these situations the subdivider or builder had no equity in the land which was to be subdivided [see, *e.g.,* R. T. 1266, 1271, 1278, 1299; 1635; 2102-2103], and entered into arrangements with LATD&ME as a last resort after finding it impossible to obtain financing through banks, savings and loan associations, or other conventional lending institutions [R. T. 1321; 1620-1621; 2100].

The basic formula for the creation of trust deeds was simple. David Farrell instructed subdividers that before LATD&ME would commit funds to any project, trust deeds and notes must be created against the property in generally the following way: The subdivider

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[23]Appendix A.

had to have under his control at least two "straw" corporations. These ordinarily were either newly organized or in some cases they were already owned by the subdivider. The subdivider would then acquire from the owner of the property an option to purchase raw acreage at a stated price. An escrow would be opened to arrange for the sale of this land to "X" corporation, one of the subdivider's controlled or "straw" corporations. "X" corporation simultaneously entered into an arrangement to sell the land at a greatly inflated price to "Y" corporation, a second "straw" corporation. The purchase price was not to be paid in cash, but by the execution of individual trust deed obligations which in aggregate face amount, greatly exceeded the total purchase price of the entire tract; "Y" corporation being the "trustor" and "X" corporation the "beneficiary" on these instruments. Contemporaneously with the arrangement between corporations "X" and "Y", a contract was executed under which LATD&ME agreed to "purchase" the trust deeds from "X". The "purchase", although effectuated at a stated discount, was for a total amount which was to (1) cover the subdivider's full cost of the entire acreage to be acquired; (2) provide funds for "servicing" of interest and of principal amortization, as required by the trust deeds for certain periods of time; and (3) purportedly finance "off-site" improvements necessary to "manufacture" lots within the proposed subdivision. Under a typical arrangement LATD&ME would deposit certain monies into the escrow, ostensibly as its purchase price for the trust deeds from "X", where in reality such monies were paid through escrow to the original landowner for the land. Thereafter, the trust deeds would

be assigned to LATD&ME and introduced into the accounts of investors under the Secured 10% Earnings Program at face value or at a discount calculated to bring "10% earnings" to investors [R. T. 1253-1279, 1299, 1302-1320; 1623-1626, 1635-1648; 2086-2101, 2102-2109, 2126-2136; also see Appendix A].

Contemporaneously with the agreement under which LATD&ME was committed to take the trust deeds, David Farrell would exact from the subdivider an agreement under which he was to receive a "participation" of not less than one-third and ordinarily one-half of the total profits that might be realized from the subdivision. These "participation" agreements were entered into by David Farrell in the names of a number of corporations which he owned,[24] a fact not disclosed to investors. In addition to these undisclosed "participations," in a typical situation, not all of the tract of land being acquired by the subdivider was encumbered by trust deeds. The more desirable and valuable tentative lots or sites were left free and clear, and David Farrell and the subdivider thereby obtained clear title to those reserved areas [GX 401; as *e.g.* R. T. 1626, 1641-1642, 1704; 2085, 2113-2114]. The entire cost was borne, of course, by LATD&ME's investors.

For their contribution, investors did not even receive trust deeds constituting valid liens against identifiable lots within an approved subdivision, as the trust deeds were created against mere tentative subdivision maps

[24]These "straw" corporations included Louvan Corporation [GX 212(a); 214], Prestige, Inc. [GX 28], Lincoln Mining Corporation [GX 400; 401], Harris & Steele Builders, Inc. [GX 64, 96]; Lantana [GX 199(a)]; Western Chemical Corp. [GX 250].

[*e.g.* GX 208, 234, 245]. In other situations, trust deeds were created against grid or area maps rather than "tentative subdivision maps." In those instances there was and could be no correspondence whatever between any *future* subdivision and the contiguous units of land against which the trust deeds were manufactured, as not even any tentative provision was made for streets, alleys or other necessary easements. The separate units were totally locked-in [GX 39; 153; R. T. 1693-1694; 2093-2095].[25] The testimony of David Farrell[26] illumines his concern for the welfare of

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[25]Exclusive of trust deeds created against mere tentative maps, LATD&ME created trust deeds and notes against grid patterns totaling at least $1,715,170 in face value. Illustrative of such trust deeds were those created against Cimaron Meadows ($630,768), Scott-Highlands ($320,000), Johnson Ranch ($295,830), and Reedlands No. 5 ($468,572). An example of a "grid" or area map (Scott-Highlands) is shown in Appendix E.

[26]Q. And you knew there was no access, no roads, no sewerage, no provision for utilities in the map, against which you created these trust deeds? You knew that, Mr. Farrell, didn't you? A. I understood there was access.

* * *

Q. Aside from use of an airplane, Mr. Farrell, and parachuting down, what access does the individual have who has a trust deed against this lot marked X?

* * *

A. Mr. Tom Schaal told me that the individual who purchased or acquired a piece of land as part of a number of pieces which were similarly sold to separate owners, had what is known as an easement of necessity over the other land, and that he could not be deprived of getting to these parcels.

* * *

Q. What did you imagine was going to happen, Mr. Farrell, if Mr. Y didn't want to allow Mr. X to come across his land, what did you think Mr. X was going to have to do to get some access to his particular parcel, Mr. Farrell, at the time you created these trust deeds?

* * *

A. I didn't consider that element.

Q. And you never advised the investors about it, did you, Mr. Farrell? A. Not that I know of.

* * *

[R. T. 4161-4162].

investors who received trust deeds covering such locked-in units of land.

An example of the manufacturing of trust deeds in accordance with David Farrell's dictates is shown by the circumstances under which 1,451 trust deeds and notes with an aggregate face value of $1,958,850 were created against a tract of land called Capitol Park Estates, and then introduced into the accounts of LATD&ME investors [GX 208(a); 2127; Appendix A].

William Bennett, a subdivider and builder, had secured an option to buy a 400-acre tract called Capitol Park Estates for a total purchase price of $1,200,000 [R. T. 1321-1323]. Bennett, unable to obtain suitable financing from conventional lending institutions, made an agreement with David Farrell to "manufacture" trust deeds against 355 acres of the tract in return for David Farrell's commitment of LATD&ME funds for the purchase of the land[27] [R. T. 1321, 1325-1326]. Pursuant to David Farrell's directions, Bennett, using a "straw" corporation, Daly-Ben Properties, Inc. (Daly-Ben), purchased the property through escrow from the original owner. In the same escrow Bennett sold the property on paper to another Bennett controlled corporation, Ben-Jay Properties, Inc. (Ben-Jay). Contemporaneously Bennett divided 355 acres of the 400-acre tract into 1,451 residential units and created 1,451 identical trust deeds, each having a face value of $1,350, with Ben-Jay as trustor and Daly-Ben as the beneficiary [R. T. 1329-1332]. The trust deeds were

[27]Prior to David Farrell's advancing any LATD&ME funds he extracted a joint venture agreement from William Bennett, providing each with a 50% interest in the entire 400 acres [R. T. 1339-1342; 1339-1342; GX 212a; 213; 214].

dated January 15, 1960, payable one percent per month including interest and matured five years from date [GX 1920; Appendix F]. Daly-Ben thus received beneficial interest in the notes and deeds of trust as "payment" for the property. The trust deeds were created against a tentative subdivision map of the 400 acres, 45 acres of which remained unencumbered [GX 208]. Daly-Ben then assigned the trust deeds to LATD&ME at a discount of 20% or $1,080 each, or for the aggregate of $1,567,000 with LATD&ME withholding $367,080 from its "purchase price" ($200,000 to be applied in servicing the monthly installments of principal and interest and $167,080 to be applied to off-site improvements) [GX 208(a); R. T. 1334-1335]. Such moneys withheld were set up in accounts designated on LATD&ME's books as "202" accounts. LATD&ME then caused $1,200,000 to be transmitted through escrow to the owners of the property [GX 216; R. T. 1332]. The 1,451 individual trust deeds and notes, each with face value of $1,350, were then placed into the accounts of investors [GX 2127]. This, despite David Farrell's knowledge that his own appraiser had valued the land secured by each individual trust deed at only $666 at the time the trust deeds were created [DF AY].

At this time not even an approved subdivision map had been filed. Estimates indicated some $2,539,000 would be required to finish or manufacture the lots [R. T. 1326]. LATD&ME "withheld" only $167,000 for that purpose [R. T. 1334-1335]. As of June 7, 1960, the entire $167,080 withheld by LATD&ME for "off-site improvements" had been disbursed [GX 214(a)]. However, up to that time nothing had been

accomplished towards creating the subdivision and manufacturing the lots except some minor engineering work [R. T. 1348]. Notwithstanding the gross inadequacy of the money "withheld" for improvements, David Farrell and William S. Bennett misappropriated at least $123,280 of the $167,000 allegedly "withheld" for improvements in the following manner: (1) the sum of $103,071 was disbursed from the "202" account to liquidate a mortgage on 13 lots in Westgate Park, California, which were owned by Farrell and Bennett [GX 214(a); R. T. 1348-1349], and $20,209 was disbursed from the "202" account to liquidate a mortgage on certain land in Sunnyvale, California, owned by Ben-Jay. Farrell and Bennett at that time each owned 50% of Ben-Jay [GX 214(a) and (b); R. T. 1350].[28]

Screening and Appraisals of Trust Deeds.

What LATD&ME Said:

Investors were led to believe that LATD&ME brought into inventory, under the Secured 10% Earnings Program, only "seasoned", "prime", and "trouble-free" trust deeds, and that all trust deeds sold to them had been carefully screened and appraised by real estate specialists and expert appraisers. Investors were also led to believe that all such trust deeds were secured by

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[28]As shown by Appendix A, similar misappropriations of funds totaling $207,000 occurred in connection with trust deeds created against Suisun and Pierce Gardens [GX 197; 197(a), 197(b); R. T. 1223-1227]; and the sum of $88.094 misappropriated from the "202" account established in connection with the creation of trust deeds on College Center [GX 205(a); 206; 219; R. T. 1313]. David Farrell and William S. Bennett were joint venturers in these situations [GX 197].

substantial underlying homeowners' equities. For example, the white brochure [GX 1666], described LATD&ME's method of selecting trust deeds in the following terms:

> "BECAUSE WE ARE THE OLDEST AND LARGEST institution of this type in America, all types of notes secured by trust deeds are offered to us in tremendous volume. These notes all go over a 'screening desk'. The very best of these notes are then carefully processed to determine the value of the property. . . ."

The description continues:

> ". . . You will note that we do not act as your agent but as principal, first purchasing these notes with our own funds after careful screening and investigation. You can thus be sure that we investigate thoroughly."

The later brochures [*e.g.* GX 843; 1667] contained a substantially identical description of the quality of the trust deeds offered to the investors, together with the following information under the heading "STANDARDS and POLICIES. . . ."

> ". . . YOUR SECURITY . . . THE AMERICAN HOME . . . BEST IN THE WORLD"
>
> "Regardless of position, each trust deed purchased by the company for subsequent resale to any customer is carefully screened, the property appraised, and the following standards observed:
>
> • A first trust deed cannot normally exceed 80% of what our appraisers determine to be the fair resale value of the property.

> • A second trust deed must (except in unusual cases) be subordinate only to a 'conventional' bank, savings and loan, or insurance company first trust deed, . . . and the total of the two liens, both first and second, cannot under most circumstances exceed 85% of the resale value of the property as determined by our appraisers.
> . . ."

Further, in the January, 1959 issue of "Trust Deed Topics", a monthly publication circulated by LATD&ME [GX 846], the following statement is made with reference to "typical" raw land developments involving trust deeds purchased by LATD&ME:

> ". . . Before Trust Deed and Mortgage Exchange makes such an investment, our appraisers must know the neighborhood involved, its probable future and be certain that property values in the area are sufficient to warrant the investment."

What LATD&ME Did:

Thomas Graham was called by appellants as their real estate appraiser [R. T. 3619]. He testified that his appraisals on improved land generally would be accomplished at the rate of "four houses a day," whereas unimproved "tracts," would be at the rate of one or two per day ". . . depending on the location and how difficult it was to find comparables" [R. T. 3625]. In most cases his tract appraisals were at a valuation "subject to improvement" [R. T. 3649], and his instructions from LATD&ME were that ". . . they wanted it per lot value when improved or an acreage value." [R. T. 3650].

Graham testified that "comparable sales,"[29] are helpful because "That helps to establish the market value. It is one point toward establishing the value of the property that you are appraising." [R. T. 3650]. He further agreed that an ". . . actual recent sale on that particular piece of property" would certainly be very helpful in arriving at an accurate fair market figure, and would necessarily have to be taken into consideration; but he would have to first check such a sale out to determine if the property was sold under the market value if distressed, or over the market, because of favorable terms or the existence of a subordination clause [R. T. 3651].

Despite the importance of these criteria, when cross-examined about several raw land subdivisions which he appraised, and which were the security for trust deeds "purchased" by LATD&ME, he had neither investigated nor had he been told by David Farrell (or anyone else) of then pending escrows through which the developer was purchasing the tracts or the actual purchase price.[30]

The promotional nature of these appraisals, and the fact that these were not meant to show actual value of the tract in its then existing condition, *but only what*

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[29]*I.e.* ". . . Sales in the same or similar areas that have actually been made that I consider comparable in value to this particular parcel" [R. T. 3650].

[30]See examples: R. T. 3657-3659 *re:* Bell Canyon Ranchos; R. T. 3667-3668 *re*: Palm Springs Alpine Village. Nor do DF-AI, M. E. Manseau's appraisal on Tract 24153, Pacoima, California; DF-AW, Graham's appraisal of Tract No. 3429, Huntington Beach, California; or DF-AY, Carpenter's appraisal of Capitol Park Estates, Sacramento, California, etc., indicate that such criteria were known or considered by the LATD&ME employed appraisers.

it might be worth if and when the subdivision was created and the lots finished, is apparent from their contents. It is also apparent that even the inflated promotional values were in some instances *far below the aggregate face value of the* trust deeds that were created against the "tentative lots" within the tract. That investors did not receive their "margin of security," as represented in all of the brochures, is obvious. The following are examples of such situations.

(1) Exhibit DF-AY—Walker W. Carpenter's[31] appraisal of February 2, 1960: "1451 R. 1 Lots 400 acres, . . . Capitol Park Estate, Sacramento (County), California."

The appraisal indicated the following information:

> ". . . An active sales campaign would be required to dispose of the lots . . . subject is undesirable because of the approach from the city . . . Improvement costs will run high for subject lots because of the high water table. . . ."

and, that realtors valued the lots "when completed, at $3,000 each." The appraiser's conclusions, as to valuation per "tentative lot" were:

"Raw land ($3,000 per acre)	$ 666.00
Est. Improvement cost	1750.00
	$2416.00
Contingencies and Profit	603.00
Total	$3,019.00

Based on the analysis of the above, *it is my opinion that Fair Market Value of Subject Lots, when improved will be . . . $3000* per lot."

[31]Walker W. Carpenter was one of Graham's "trainee" appraisers [R. T. 3677].

With this appraisal already completed, on February 10, 1960, LATD&ME brought into inventory 1451 trust deeds, each having a face value of $1350.00, or an aggregate face value of $1,958,850 there being no improvements nor subdivision map of record at the time [GX 208; 208(a)]. Each trust deed was "security" for a "lot," then appraised at a value of only $666.00; an overvaluation on each trust deed of $684.00 *over their own appraisal.*

(2) Exhibit DF-AZ, Weeks' extensive appraisal of "Tracts 1078, 1079, and 1274,"[32] dated September 1, 1959 contained the following information:

> ". . . the market value of these properties as of 9-1-59 is as follows:
>
> | | | |
> |---|---|---|
> | Tract 1078 | | $1,174,600 |
> | Tract 1079 | | 197,250 |
> | Tract 1274 | | 63,550 |
> | | Total | $1,435,400" |

Weeks rounded that figure to "$1,435,000", and stated that his conclusions were predicated upon certain "limiting conditions," which included the following:

> ". . . 6. That the proposed land improvements affecting Tract 1078 will be installed: ". . . land improvements consisting of:
>
> 1. Street paving,
>
> 2. Gas, water and electric services available to each lot.
>
> 3. A permanent storm drain along Lot F and C, be installed and all costs be paid by the developer."

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[32]This is the "Villa Nipomo" tract located in the Saugus-Newhall, California, area [R. T. 3678-3680].

Weeks included a series of photographs at the end of his appraisal, including picture "no. 6," which showed ". . . the present condition of wash in North part of Tract 1078"[33]

Despite this appraisal information, LATD&ME "purchased" 2139 trust deeds, created via the "straw" corporation, "purchase money" method, on *portions* of tracts 1078, 1079 and 1274. These trust deeds had an aggregate face value of $1,982,075 [GX 94 and 99], despite the fact that *all* of 1078, 1079, 1274 *and* 1801 had simultaneously been purchased by Villa Nipomo, Inc. from Los Angeles Home Company for a total purchase price of $810,000, the exact value the stockholders of the seller placed on the entire tract [R. T. 2035, 2038-2039, 2041, 2077].

Examples of how grossly these 2139 trust deeds were over-valued, may be seen with the following comparisons to their own appraisal [DF-AY]. A total of 16 trust deeds were created against Lot 9, Block 205, Tract 1078, each having a face value of $1400 and each being confirmed to an investor's account (including that of witness Eppley). The aggregate face value of the 16 trust deeds, $22,400, is fantastically higher than was Weeks' *"if and when"*

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[33]See Robert Rosskopf's testimony, he being the attorney for Los Angeles Home Company, the original seller of the tract to Villa Nipomo, Inc., for his description of the property [R. T. 2040-2041, 2045, 2047].

Curiously, when LATD&ME's Graham appraised Tract 1078, he did not even know there was a wash problem although he testified that he considered " . . . the probability of being able to dispose of it for industrial sites. That is what they proposed, I believe, to make an industrial subdivision of it. And I questioned whether or not they would be able to put it over on any reasonable basis, because I thought there was too much of it for an industrial district" [R. T. 3679-3681].

appraisal of $6,000 for *the entire lot* [GX 10076];[34] which amounts to approximately $428.60 "security" for each $1400 trust deed.

(3) Exhibit DF-AH, Graham's appraisal of Bell Canyon Ranchos, in conjunction with his testimony reveals the following information:

Both appraisal and testimony indicated that there would be development problems with this property, because of steep hills, necessity of "building pads," and water problems [R. T. 3664].

Graham spent only "a couple of hours" on this appraisal, and no one, including David Farrell, told him that the tract was in escrow at that time at a sales price of $3421 per acre. Nor did he investigate to determine such information prior to appraising the entire 176 acres at $7,000 per acre [R. T. 3658-3662].

Graham testified that it would cost about $2200 per acre to develop this tract, and that approximately three lots could be developed per acre [R. T. 3664-3665].

Despite this information, LATD&ME brought into inventory 302 trust deeds created against only 86 of the 176 acres [R. T. 4213], each having a face value of $4,000, or an aggregate of $1,208,000 [GX 245; 246]. According to Graham's analysis, with three lots per acre, and the acre valuation being $7000, each *lot* would have an appraised "fair market value" of only

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[34]To the same effect see for example GX 10063, indicating 16 trust deeds and notes with an aggregate face value of $22,400 encumbering a lot appraised by LATD&ME's own appraiser at $6,000; GX 10064 indicating 8 trust deeds and notes with an aggregate face value of $11,200 encumbering a lot appraised by LATD&ME's own appraiser at $3,000.

$2,333.[35] Comparing this value with the $4000 trust deeds against each of such lots, there was an aggregate appraised value of $704,566 to support $1,208,000 in trust deeds.[36]

Adding further depth to this indefensible conduct, knowing that a total of $664,400 would be needed to improve the 302 "lots," LATD&ME "withheld" only $149,999 in its "202 account" for "improvements." [GX 246, 260(d)].

(4) Exhibit DF-AV, Graham's appraisal on Palm Springs Alpine Village.

In the appraisal, Graham noted that the 653 lots on 680 acres, covered raw land, there being no improvements, and no zoning yet obtained, and concluded, ". . . my opinion that subject lots, *when improved* will have an average Fair Market Value of *$2900* per lot."

In his testimony Graham stated that the raw land, in its then unimproved state, was worth only $62 to $100 per lot, and that his appraisal was based on consideration of the improvements that would be made in the future [R. T. 3671-3674].

Graham further testified that he did not know that 3800 acres was about to be released for a total of $212,000 (which *included* the 680 acres he appraised), nor that that sale was finalized within 20 days of his appraisal [R. T. 3667-3668].

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[35]Even this assumes all improvements would be completed at a cost of $2,200 per lot.

[36]The difference becomes even more monstrous if the $2,200 per lot were deducted from the $2,333 "fair market value."

This property was encumbered with 653 trust deeds, each having a face value of $1200 or an aggregate face value of $783,600 [GX 393(a); 405].

(5) Exhibit DF-AW, Graham's appraisal: "Subject Tract No. 3429 — Land Appraisal, Huntington Beach, California. For: David Farrell".

This appraisal, dated 9-24-59, disclosed the following information:

> "The entire area is farm land. It is about 1 mile to the nearest urban development and that is scattered and minimum construction. . . . 1250 raw land cost per lot. . . . Improvements in this area cost about $1500 per lot, making a cost of $2750 per lot. Counting costs and profits yields a value of $3500 . . .
>
> *It is therefore my opinion that subjects lots will have a market value of $3500 when manufactured.*"

A total of 186 trust deeds was placed against this property, each having a face value of $3150, in the name of "Cal-State Investments" [GX 416]. The aggregate face value was $585,900. The trust deeds were "purchased" by LATD&ME on 11-16-59 [GX 416].

Graham testified that the raw land here was appraised at only $1250 per lot, and would not at that time, have sustained an encumbrance of $3100 per lot [R. T. 3675-3676].

Misappropriation of Investors' "Windfall Profits."

Throughout the Secured 10% Earnings Program, it was represented to investors that in the event the trustors or makers of trust deed notes held in investors' portfolios should liquidate their obligations in advance of maturity, such investors would "earn" more than the promised 10% as a consequence of their ownership of the obligations being liquidated [R. T. 716-717; GX 2136-2138]. Indeed, in the first stage of the Secured 10% Earnings Program, LATD&ME did credit the investor with the full amount received in connection with such advance liquidations or "pay-offs" [R. T. 917-918]. This uncharacteristic policy of honest treatment did not continue for long and was soon revised. Early in 1959, without any notification to investors, the entire accounting procedure was changed. Thereafter, when LATD&ME received notice from the escrow holder that a trust deed note was to be paid off in full in advance of maturity, LATD&ME simply notified the investor that the trust deed was being repurchased ". . . according to our regular procedure whenever further action is required." [GX 695]. The trust deed was then withdrawn from the investor's account, which was credited only with the original cost of the trust deed, less any amount theretofore paid by the trustor to apply on principal. LATD&ME then proceeded to collect the full amount through the escrow, and retained the difference between the amount credited to the investor and the amount received from the trustor. For example, when a trust deed note bearing 10% interest was paid off in advance of maturity, the investor

was credited with the *current unpaid balance* of the note while LATD&ME received not only the current unpaid balance, but all accrued and unpaid interest. LATD&ME retained these interest accruals [R. T. 917-920]. In these situations the amount received by LATD&ME after withdrawing the trust deed from the investor's account always exceeded the amount credited to the investor [R. T. 2746].

A single example will serve to illustrate this technique used in manipulating investors' accounts. On March 20, 1959, LATD&ME purchased TD No. 7195M for inventory for $3,274 [GX 698], and on May 1, 1959, confirmed it to the account of W. A. Griswold for $4,112 [GX 699]. About August 4, 1959, LATD&ME was notified by Bank of America that the trustor had opened an escrow in order to liquidate the obligation evidenced by the trust deed. Bank of America requested LATD&ME to forward the documents required to accomplish reconveyance [GX 709]. On August 20, 1959, LATD&ME sent the instruments of reconveyance to Bank of America, together with instructions that the unpaid balance on the note, together with accrued interest amounted to $4,377 plus interest [GX 711]. On September 8, 1959, the bank sent its check for $4,459 to LATD&ME [GX 710]. *The next day,* September 9, 1959, LATD&ME advised the investor that it was "necessary to withdraw" the trust deed from his account, in accordance with "our regular procedure whenever further action is required" [GX 712]. *Nine days later,* on September 18, 1959, the investor's ledger account was credited with $4,027 [GX 696]. Thus, in this situation, LATD&ME, "in accordance

with [its] regular procedure" misappropriated $432 belonging to the investor.

There is set out in Appendix G a schedule [GX 1893] showing similar manipulations of investors' accounts and the misappropriation by LATD&ME of "windfall profits" which should have accrued to investors. The schedule which covers 50 accounts reflects the misappropriation of amounts as small as $22 and as large as $770. The average is $170 [R. T. 2746].

"Big Board" or "Open Market" Trading.

The brochures describing the "Secured 10% Earnings Program" credited David Farrell with ". . . creating an entirely new industry when he originated 'big board' and 'open market' trading in trust deed investments . . ." [GX 843; 1667; 1668; 1669; 1670; 1672; 1674]. Through the "big board" and "open market" trading, LATD&ME professed to offer investors an "exchange," similar to a national securities exchange, which would effectuate ". . . a 'stabilization policy' relative to such notes and purchases . . . at prices above those normal in the market" [GX 1666]. LATD&ME salesmen used impressive photographs and brochures stressing the significance of the "big board" in stabilizing the trust deed market [GX 843; 1401; 1666; 1667; 1668; 1669; 1670; 1672; 1674; R. T. 539-542].

In fact, the "big board" had nothing to do with the "Secured 10% Earnings Program" and its sole function was to mislead investors into believing that trust deeds introduced into their accounts could be liquidated at any time through LATD&ME's trading facilities [R. T. 539-542, 697; also see *infra* "Role of Oliver J. Farrell in Scheme to Defraud"].

Misrepresentations as to Liquidity.

LATD&ME, stressing their financial liquidity, represented to investors they ". . . maintain a financial liquidity (cash to total liabilities) higher than most of the banks, savings and loan associations and security brokers" [for *e.g.,* GX 843]. This representation was false as evidenced by an analysis of LATD&ME's financial position at a number of dates computed in accordance with the "net capital" rule promulgated by the SEC, and applicable to brokers and dealers in securities [GX 1055; R. T. 2669-2670]. In general, the "net capital" rule requires brokers and dealers to maintain cash or other *liquid assets* of not less than one dollar for every twenty dollars of aggregate indebtedness. In computing the value of "liquid assets" held by brokers and dealers, the rule requires that securities held in inventory be reduced by thirty percent of current market value in order to accommodate downward changes in market prices [R. T. 2662-2670]. It was emphasized the rule establishes the *minimum* standard of liquidity [R. T. 2642-2643].

LATD&ME at no time maintained liquid assets sufficient to satisfy the minimum requirements applicable to brokers and dealers in securities. On the contrary, as evidenced by computations found in Appendix H [GX 1055; R. T. 2669-2670], after the most generous allowances for the value of trust deeds in inventory (including those in default and in process of foreclosure), LATD&ME's financial condition, computed in accordance with the "net capital rule," was in continuous deficit.

Concealment From Investors of the True Nature of the Civil Litigation With Securities and Exchange Commission.

From March 24, 1958, until June 8, 1960, when the receivership was established, appellants sought to conceal from investors the fact that the Securities and Exchange Commission had brought the entire Secured 10% Earnings Program into serious question with a suit which, among other things, alleged appellants were engaging in a course of business which constituted a fraud and deceit upon members of the investing public. This deliberate policy of concealment continued even after October 8, 1958, when the SEC amended its original complaint to include allegations of insolvency, misappropriation of funds of Secured 10% Earnings investors and requested the appointment of a receiver [GX 1432].

Notwithstanding the grave nature of the charges made by the SEC and the shadow of receivership that hung over the enterprise, the brochures, *without mentioning the civil action,* assured investors that:

> "Legal aspects of our Secured 10% Earnings Accounts have been evaluated and approved by counsel for the company, Mr. Morgan Cuthbertson, former counsel for the Securities and Exchange Commission." [GX 843; 1667].

Mr. Cuthbertson characterized this statement as a misrepresentation, and denied that he had ever evaluated or approved the legal aspects of the Secured 10% Earnings Program [R. T. 3491-3492].

The appellants not only concealed from investors the very existence of the charges, but if a question was raised by an investor regarding the nature of the litigation, salesmen were instructed to state that the sole question was "jurisdictional." As Oliver J. Farrell instructed all personnel handling correspondence for Trust Deed & Mortgage Exchange:

> "*What's With The SEC?*
>
> The civil suit now pending in connection with the Securities and Exchange Commission, is simply an airing of our Secured 10% Earnings in order to get the ruling by a Federal Court as to whether or not we are selling securities which require a registration . . ." [GX 2102].

The appellants' policy of misrepresenting the nature and status of the civil suit and the findings of the courts reached its apex immediately after this court had reversed the preliminary decree entered by the district court, *Los Angeles Trust Deed and Mortgage Exchange v. S.E.C.*, 264 F. 2d 199 (9th Cir. 1959). The March, 1959, issue of Trust Deed Topics [GX 846] contained a grossly distorted, truncated and misleading summary interpreting the reversing opinion. [Appendix I.]

Thus, until the very moment the receiver intervened, investors trustingly deposited their savings with LATD&ME in entire ignorance of the very existence of the serious allegations made by the SEC and the impending receivership. For example, on May 26, 1960, six days after the district court entered its final decree, appellant David Farrell, sent a letter welcoming Laddie J. Stewart, a serviceman stationed abroad, to "our large family of customers." [GX 586].

Insolvency of LATD&ME.

LATD&ME's investors were misled by the company's slogan that: "No Secured 10% Earnings Customer has ever sustained a loss" [GX 842; 843; 846; 1668; 1670; 1674]. The eventual realization of losses was continually postponed by the very nature of the scheme to defraud. Investors were persuaded to take their "Secured 10% Earnings" on paper, leaving their actual cash in the hands of the company. As soon as LATD&ME's source of fresh funds was exceeded by the cash outflow for "secured earnings" and the honoring of liquidation requests, appellants' financial empire collapsed.

As of March 31, 1959 LATD&ME was insolvent in a bankruptcy sense, in the amount of $176,000 [R. T. 2670-2682; GX 1054; 1074; Appendix J]. By June 7, 1960, the day before the receiver took over, the excess of total liabilities over total assets had grown to at least $1,250,000 [R. T. 2840, 2843, 2844, 2849, 2854, 2859-2861; GX 6005; Appendix K].

In addition, of $39,000,000 in trust deed notes which LATD&ME held for servicing for investors, 2717 totaling $8,500,000 in face value were delinquent [R. T. 2779-2780, 2809-2811; GX 6001(c); Appendix L]. These $8,500,000 delinquent trust deeds did not include the 13,700 trust deeds totaling $17,000,000 in face value which were being serviced as to interest and principal from "202" accounts established by LATD&ME at the time the trust deeds were created [R. T. 2803, 2804, 2864-2867; Appendix A]. LATD&ME's actual cash on hand when the receiver took over was over $2,000,000 short of that necessary to cover the $2,367,000 in book

entries credited on the corporation books as "withheld" money to service the trust deeds and notes [R. T. 2866-2868].

LATD&ME had pending, *prior* to receivership some 800 customer demands for liquidation of accounts totaling $3,600,000 which had not and could not be honored R. T. 2801, 2867-2868; GX 6002; 6003].

Method of Presentation of Secured 10% Earnings Program to Investors.

The appellants instructed all personnel of LATD&ME to so present the Secured 10% Earnings Program to the investing public that they would rely completely on LATD&ME's financial stability and liquidity. LATD&ME salesmen represented to some investors that LATD&ME was a financial institution similar to a bank or savings and loan association [R. T. 1024; 1108; 1156; 1845]. Others, and perhaps the majority of investors, were led to believe that they were making deposits into an integrated investment program under which LATD&ME provided a safe, stable and liquid investment together with 10% earnings, and, in addition, their accounts would be secured by prime, trouble free and seasoned trust deeds [R. T. 1039; 1408-1409; 1529-1532; 1811; 1974-1979; 1988-1993; 2003-2007; 2188; 2258]. Thus, investors were induced to believe that LATD&ME was basically a bank-like institution [R. T. 764-765; 1024; 1108; 1156; 1836-1837; 1845; 1907-1909]. They were told they could withdraw their funds just as they could from a bank [R. T. 1156; 1845], and were led to understand that LATD&ME "guaranteed" their accounts in a manner similar to insured bank deposits [R. T. 1907-1909], and that

LATD&ME "guaranteed" 10% earnings [R. T. 1024; 1107; 2176]. Investors were given LATD&ME passbooks, resembling bank savings account passbooks, in which their deposits were recorded [GX 621; 866; 1221; 1259; R. T. 1024; 1845]. Some investors were confused and uncertain as to the relationship of trust deeds to LATD&ME's Secured 10% Earnings Program [R. T. 1109-1110; 1155; 1800; 1837; 1849; 1869-1870]. They were not told that they were buying trust deeds [R. T. 1108; 1800; 1837; 1849; 1869-1870; 1882] but on the contrary, were led to understand that they were depositing their funds with LATD&ME, who, in turn, was investing in real estate and trust deeds [R. T. 1108-1110; 1154; 1795; 1869-1870; 1889]. Investors, falling within this category, often did not want to purchase trust deeds or similar instruments [R. T. 1108; 1800; 1837; 1849; 1869-1870; 1892]. Nevertheless, they were induced to withdraw funds from nonspeculative savings media, such as banks, savings and loan associations and life insurance companies [R. T. 1010; 1159; 1835-1836; 1846], in order to invest in what was represented to them to be an equally safe and secure financial institution [R. T. 1011; 1153, 1156; 1836; 1845].

The misunderstanding that LATD&ME was like a bank was fostered, in no small way, by LATD&ME's bank-like appearance[38] and salesmen's frequent compar-

[38]LATD&ME intentionally created confusion in the minds of investors by leading them to believe that the institution was similar to a bank as evidenced by David Farrell's instructions to employees of LATD&ME's main office that they endeavor to create a "bank-like" atmosphere [R. T. 156-157]. These instructions were apparently well carried out since investors visiting the main office observed the bank-like atmosphere so created [R. T. 1163; 1413].

ison of the company with a bank. Salesmen utilized such language as: an investment with LATD&ME was "As safe as money in the bank . . ." [R. T. 1836]; ". . . was a better risk than the California Bank . . ." [R. T. 1533]; ". . . As safe as any bank." [R. T. 1961]; and ". . . just as if it were down at the corner bank" [R. T. 1976].

Many of LATD&ME's investors were cognizant that the purchase by them of trust deeds constituted an essential element of LATD&ME's integrated investment program [R. T. 1043; 1140-1142; 1408-1409; 1528; 1811; 1923-1924; 1974-1979; 1988-1993; 2187-2188; 2258]. These investors believed that they were investing under a program offered by LATD&ME [R. T. 1098; 1408-1409; 1546-1547; 1811-1812; 1961; 1974-1976; 2187-2188], and looked to LATD&ME to select safe and secure trust deeds [R. T. 1039; 1041; 1141; 1411, 1417, 1422; 1530-1531; 1975; 2258-2259]; to provide essential services in collecting and servicing trust deeds, and to provide professional management over their accounts [R. T. 1098; 1413, 1417, 1422; 1537, 1546-1547; 1961; 1991-1992]. They looked to LATD&ME, and not the trust deeds in their accounts, for the secured 10% return [R. T. 1962; 2281]. They were also led to believe that in addition to the security provided by the trust deeds in their accounts, LATD&-ME stood behind their investments [R. T. 1408-1409; 1537; 2189-2190].

One investor witness testified about the following analogy, which was related to him by a LATD&ME salesman [R. T. 1408-1409], and later repeated by David Farrell [R. T. 1418-1419]:[39]

> ". . . he compared their operation, that is, the LATD, to a double-hulled ship. He said the outside hull is the company; the company stands behind your investment, and any time you want you can cash it in. And that is not all: There is an inner hull, a safety hull. That is the property itself. That for this particular program we pick good properties, and your investment will be protected by them even if the company was not in existence." [R. T. 1408-1409].

LATD&ME salesmen represented to investors that the company's Secured 10% Earnings Program included only sound and secure trust deeds; that LATD&ME invested in "seasoned deeds of trust" [R. T. 2188]; ". . . bought nothing but the best . . ." [R. T. 1926]; ". . . made very sound investments . . . nothing speculative . . ." [R. T. 1041]; ". . . the trust deed was amply covered by an excess in valuation of the property . . ." [R. T. 2259];[40] ". . . men go out and appraise the property, and that if it was a good risk they bought them in, and if it wasn't, they refused them" [R. T. 1531].

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[39]David Farrell represented to this investor that he would personally approve the selection of trust deeds for his account [R. T. 1417-1418]. Nevertheless, LATD&ME failed to withdraw delinquent trust deeds from the investor's account [R. T. 1465], and even introduced trust deeds into the account which were already in default [GX 764; 1186].

[40]Compare with section in this brief relating to LATD&ME's appraisal policy, entitled "Screening and Appraisals of Trust Deeds."

Based on representations made to them by the salesmen, and the concept of "the American Home" as security [GX 842; 843; 844; 992(b); 1668; 1669], numerous investors were led to believe that trust deeds selected for the Secured 10% Earnings Program were secured by owner-occupied homes, apartments or other buildings [R. T. 722, 725; 1041; 1535; 1923-1924; 1991; 2188; 2756]. Many were disillusioned, and after examining some of the tracts against which their trust deeds were created noted that "It was just a piece of desert right next to the mountains . . . No streets . . . No stores around. Just dirt roads" [Tract 1078—Newhall, California, R. T. 1966-1968]; ". . . It is a vast area, sloping hillside, all covered with brush; nothing developed whatsoever . . . No roads whatever . . . Nothing had been done. It was a wilderness, the way it had been for years." [Reedlands Unit No. 5, R. T. 1877-1879]; "A bare field" [Capitol Park Estates, R. T. 1931-1932]; and "Very, very sparsely settled. As a matter of fact, no houses could be seen from the place where my lot was situated" [Palm Springs Alpine Estates, R. T. 1981-1983]. Other investors ultimately discovered that the trust deeds introduced into their accounts by LATD&ME had been created against grids without any means of ingress or egress; they described the property in the following terms ". . . we were in the center of a piece of property to which we couldn't get in or out; and that it was a very small thing that was absolutely worthless" [R. T. 2285].

LATD&ME mailed out to investors an instrument designated as "Confirmation" or "Program Sell Order & Confirmation," which purported to confirm to in-

vestors the sale to them by LATD&ME of trust deeds and to give a very brief description of the underlying trust deed security [GX 788; 796; 867(a)]. These confirmations failed to fully describe prior liens [GX 788; 796; 867(a); R. T. 1484-1493; 1557-1558]; stated falsely that homes and buildings were being constructed [GX 869(a); R. T. 1565-1566] and contained other incomplete and inaccurate descriptions [R. T. 1462-1463; 1575-1577]. On the basis of such confirmations, investors were asked to accept or reject the trust deeds [GX 1668, p. 10]. Salesmen of LATD&ME, when asked by investors regarding individual trust deeds, replied with spurious information, such as stating that buildings were being constructed, when, in fact, there was nothing but a vacant parcel of land [R. T. 1565-1566, 1578-1579]. Moreover, investors were led to believe that it was not necessary for them to inspect the property on which they were assigned trust deeds as they could depend on LATD&ME's skilled staff to make sound selections [R. T. 1431; 1975-1976; 1991-1992]. That investors did so rely on LATD&ME's expertise is evidenced by the very low rate of rejection of trust deeds introduced into their accounts [R. T. 255; 614; GX 1623].

Investors also relied upon the statement in LATD&ME's brochures [GX 842; 843; 844; 992(b); 1668; 1669] that the total value of the first and second deeds of trust ". . . cannot under most circumstances exceed 85% of the resale value of the property as determined by our appraisers" [R. T. 1529-1530; 1925; 2189]. Although investors were informed both by the salesmen [R. T. 1923; 2189; 2267] and through

the sales literature [GX 842; 843; 844; 992(b); 1668; 1669], that it was the policy of LATD&ME to replace defaulted or delinquent trust deeds with trust deeds of good standing, delinquent trust deeds were not withdrawn from the accounts of investors [R. T. 1099; 1176-1177; 1465; GX 515; 764; 817]. It was further the policy of LATD&ME to encourage investors to have the company retain title in the name of LATD&ME, as "Trustee", so as to facilitate the processing and possible liquidation of the trust deeds [R. T. 205]. Investors were thus kept in ignorance of LATD&ME's internal accounting procedures,[41] and could not, and did not know whether specific trust deeds assigned to their accounts were being kept current. In some instances, trust deeds which were already in default were introduced into the accounts of investors [GX 764; 1186].

The confirmations mailed to investors to confirm the sale to them of trust deeds contained the notation "Balance on Terms" which indicated the amount by which the investors was still indebted to LATD&ME for the specific trust deed; LATD&ME considered and treated this debit balance as a demand obligation owed to it by investors [R. T. 2406]. The investors, however, were not made aware of the fact that LATD&ME considered these items as demand obligations. Many investors were not ever aware that the designation "Balance on Terms" indicated that they were indebted to LATD&ME in any manner whatsoever [R. T. 1063-1064; 1118; 1168-1169; 1837; 1854; 1873; 2018].

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[41]Appellants stipulated at trial that none of the investors saw the internal records of LATD&ME [R. T. 1125-1126].

The very core of the Secured 10% Earnings Program and the factor which catapulted the program into wide acceptance, was the mailing to investors, monthly, of condensed summaries [GX 1270; Appendix D], graphically portraying the growth of investors' accounts through 10% interest compounded monthly. The investors understood the figures in the right-hand column of this summary— "Estimated Liquidation Value of All Assets in Your Account", as representing the total of their deposits combined with the 10% earnings therefrom [R. T. 775; 1122; 1164-1165, 1175; 1801; 1838-1839; 1855; 1902; 1930; 1963; 1984; 1994-1995; 2179; 2198; 2279]. All investors, regardless of their understanding of the Secured 10% Earnings Program, accepted the summary as proof that their funds were in fact earning 10% [R. T. 775; 1122; 1164-1165; 1175; 1801; 1838-1839; 1855; 1902; 1930; 1963; 1984; 1994-1995; 2179; 2198; 2279]. They believed that the amount shown represented LATD&ME's total indebtedness to them, which was due and payable whenever they elected to liquidate their accounts [R. T. 775; 1801; 1930]. The condensed summary, showing the growth of the account, influenced investors to add further funds to their accounts [R. T. 1930; 1994-1995].

Investors were told by salesmen that LATD&ME would promptly fulfill requests for the complete, or partial, liquidation of customer accounts [R. T. 1012-1013; 1110; 1139-1140; 1156; 1408-1409; 1531; 1812; 1845; 1868, 1888, 1890; 1993; 2008; 2756]. The represen-

tation as to liquidity was unequivocal and without the qualifying caveat that LATD&ME would effect liquidation only on a "best efforts" basis [R. T. 1419; 1845; 1890].[42]

Even after the decision of the district court on May 20, 1960, appointing a receiver, salesmen continued to represent that liquidation could be accomplished ". . . within a day or two or three, at the very most . . ." [R. T. 1013]; as soon as the investor ". . . would write into the company . . ." [R. T. 2756]; and ". . . it usually took about a day to find another buyer, but at the most ten days to two weeks" [R. T. 1140]. As late as June 2, 1960, Oliver J. Farrell wrote to a Connecticut investor, stating: "With respect to liquidation, under normal conditions your request can be processed within a week's time. However, in the event of a heavy work load we would appreciate an advance request" [GX 641(a); R. T. 1993]. Oliver J. Farrell did not disclose in this letter that LATD&ME had at that time established a moratorium on honoring liquidation requests [GX 641(a)].

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[42]One investor testified as to the following conversation with David Farrell regarding LATD&ME's liquidation policy:

> "Q. Did you discuss at all, sir, the situation which might arise wherein the company would repurchase any trust deeds from you or your account? A. We never went into any of the details on that. All he did was assure me that all I had to do if I need cash, all or part of it, all I had to do was write a letter and I would get it. It meant to me that the account was completely liquid.
>
> Q. Was anything said about being on a best effort basis that you would be able to get your money out? A. No, I never heard that word or anything like it" [R. T. 1419].

See Oliver J. Farrell's similar explanation in portion of fact statement entitled "Role of Oliver J. Farrell in Scheme to Defraud".

LATD&ME salesmen failed to voluntarily disclose to investors the litigation between the company and the SEC [R. T. 1022-1024; 1120; 1138-1139; 1511-1512; 1801; 1839; 1870; 1962; 2182]; however, if the investors questioned them regarding this matter, LATD&ME salesmen characterized the litigation as a "test case" to establish the SEC's jurisdiction over LATD&ME [R. T. 765-769; 1101; 3298-3299]. They did not disclose that LATD&ME was charged with fraud and insolvency [R. T. 765-769; 1101; 3298-3299]. Salesmen also represented to investors that the litigation with the SEC had been instigated by the banking industry because it was losing customers to LATD&ME, using such language as ". . . the judge that was ruling against this was a member of a banking family, so consequently he was prejudiced . . ." [R. T. 1138]; ". . . the litigation was because the banking interests and the building and loan companies were so opposed to this sort of transaction—that they were doing the same things as Los Angeles Trust Deed, and making equally as much money, but only paying the public 2½ or 3 or 3½%." [R. T. 2276]; and "We had some trouble there, it was caused by the banks and savings and loans. They don't want us to get in on this" [R. T. 1532].

Even after the final decree was entered by the district court on May 20, 1960, LATD&ME solicited the accounts of new customers and accepted deposits of existing customers without disclosing the existence or results of the SEC litigation [R. T. 1022-1024; 1120; 1138-1139; 1904]. Between May 20, 1960, and June 8, 1960, the date the receiver took control of LATD&ME, salesmen continued to solicit and accept deposits

from investors [R. T. 1014-1015; 1120-1121; 1146; 1904, 2756], including investors residing outside of California [GX 642; 646; 829(a); 1001], and in overseas military installations [GX 583; 585; 586]. Such investors, pursuant to appellants' instructions, were not informed of the impending receivership [R. T. 1012-1013; 1120; 1138-1139; 1904]; instead, they were told by salesmen, during this period, that LATD&ME was ". . . as solvent as any bank or any savings and loan association" [R. T. 1011]. LATD&ME's salesmen not only solicited new accounts, they also persuaded existing investors not to liquidate or to defer liquidating their accounts [R. T. 765-769; 1828-1830; 1904-1905], by representing that LATD&ME was sound [R. T. 765-769; 1828-1830]. Oliver J. Farrell, during this period, induced investors to retain their accounts, stating that ". . . everything would be all right" and ". . . that this was a test case" [R. T. 766]. Investors who deposited their money with LATD&ME during the period May 20-June 8, 1960, were not assigned any trust deeds, nor did they receive their investment back on any earnings thereon. [R. T. 1017; 1148; 2761-2762].

Role of Oliver J. Farrell in Scheme to Defraud.

Oliver J. Farrell was sales manager of LATD&ME, as well as its secretary, vice-president, and one of its directors, from the inception of the Secured 10% Earnings Program, until the date the receiver took over.[43]

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[43]Oliver J. Farrell himself gave a fairly thorough résumé of his role and duties at LATD&ME in his "Position Description Questionnaire" [GX 2200], a portion of which is reproduced as Appendix M.

Also, he was vice-president and a director of TD&MM [R. T. 3111-3113].

Oliver J. Farrell employed, trained and supervised all local LATD&ME account advisers (salesmen) and conducted weekly sales meetings throughout California, instructing salesmen in effective sales techniques [R. T. 159, 3117]. All directives to branch office managers and salesmen emanated from him. He conducted "inspirational" conferences for new salesmen [R. T. 159]. All branch office managers took their orders from and were directly answerable to him [R. T. 509, 3114]. They went to him with "most any kind of a problem" [R. T. 159]. Oliver J. Farrell also wrote the sales meeting speeches and edited literature that was mailed out to investors [R. T. 160]. His letters to investors, as well as those of David Farrell were used as formats for form letters to investors [R. T. 208]. In short, no one else had authority to distribute anything out of the sales department which had not first been approved by Oliver J. Farrell [R. T. 3140].

Oliver J. Farrell testified that the liquidation policy of LATD&ME

> ". . . was to make a customer's funds available to him upon request by liquidating his trust deeds, either by purchasing them back for the company's account or by reassigning them to other customers who had money awaiting for the purchase of trust deeds" [R. T. 3102].

This is the same policy expressed in an "Outline of 3rd Sales Meeting" [GX 1413], in which he pointed out certain "magic words" the salesmen should use. There under the example "BECAUSE," he said:

> ". . . you can always get your money back out of a Secured 10% Earnings Fund BECAUSE all we have to do is assign the Trust Deeds in your portfolio to other customers or re-assign them back into our warehouse. It's as simple as that."[44]

Oliver J. Farrell instructed Frank Stark (Northern California regional sales manager and vice-president of LATD&ME), that the salesmen should stress the importance of the "big board" in selling the Secured 10% Earnings Program. Stark was directed to create the impression that the "big board" was useful in liquidating 10% earnings accounts [R. T. 541], although in fact it had no connection with the Secured 10% Earnings Program [R. T. 541-542; 697]. Nevertheless, Stark and his salesmen, pursuant to Oliver J. Farrell's orders, stressed the importance of the "big board" in selling the Secured 10% Earnings Program [R. T. 544; GX 1401].

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[44] *Cf.* this to the contention made in Brief D. F., p. 46, suggesting the evidence was clear and undisputed that the policy of LATD&ME was "that liquidation or sell orders will be handled 'on a best effort basis only'." Oliver J. Farrell himself rebuts this allegation as seen *supra,* as did investors whose testimony revealed that they were told they could liquidate within a short period of time, with no reference being made to on "a best efforts basis."

Oliver J. Farrell had a major role in drafting an article in January, 1959, Trust Deed Topics [GX 846] describing subordinated trust deeds that LATD&ME was introducing into investors' accounts. Reprints of this article were sent to LATD&ME salesmen, and to all investors receiving such trust deeds [R. T. 3145, 3146]. The article was intended to convince investors who were receiving subordinated trust deeds created against units of raw land that the subdividers had large cash equities in the subdivisions [R. T. 3146, 3152-3155]. In addition, pursuant to Oliver J. Farrell's instructions, salesmen displayed to potential investors the current LATD&ME brochures, pointing to a photograph of an "American home" and the statement:

> ". . . If you sold your home and the person to whom you sold it made substantial down payment and you took back a second trust deed, you would feel relatively safe, wouldn't you? Such trust deeds against individual real estate sold by property owners who receive a substantial down payment, are the type which we generally purchase and sell to you" [GX 444; 843; R. T. 3152-3154].

Thus, it was at the specific direction of Oliver J. Farrell that salesmen represented to investors that the subdividers who created trust deeds for LATD&ME against vacant tracts of land had made large cash investments in the subdivisions. The facts were, of course, that thousands of trust deeds were being manufactured against raw land in situations where the subdividers had not invested a single dollar.

Throughout the Secured 10% Earnings Program, Oliver J. Farrell instructed salesmen to represent that LATD&ME's *own* funds were being used to purchase trust deeds for inventory notwithstanding his knowledge that investors' money was in fact being deposited into the company's general accounts and used for the acquisition of trust deeds [R. T. 602-603; 3160-3161].[45]

With reference to the SEC litigation, Oliver J. Farrell instructed salesmen that no information was to be given unless the question was specifically asked. Even then, salesmen were to emphasize that the crux of the litigation was a dispute over SEC's jurisdiction to regulate institutions such as LATD&ME. The allegations of fraud and insolvency made by SEC were never to be brought up [R. T. 563; 566, 567].

Oliver J. Farrell admitted he "had heard" of some of the corporations through which David Farrell had received participations from subdividers [R. T. 3162], and that ". . .[he] had knowledge, but not specific knowledge as to some of these developments" [R. T. 3164]. He admitted that in late 1958 he discussed with his brother "some aspects" pertaining to the "participation" agreements [R. T. 3163], and that he knew his brother David was enjoying certain profits from "participation" arrangements [R. T. 3164, 3165].

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[45]See also white brochure [GX 1666] for representations that investors' money would be deposited in a trust account. David Farrell similarly represented that investors' money would not go into the general accounts of the company [R. T. 1422].

Oliver J. Farrell's compensation for the two and one-half years he served as sales manager for LATD& ME was in excess of $250,000 [R. T. 2608, 2609; GX 7801]. In addition, he obtained four lots in his own name in Embarcardaro Rancho [R. T. 3156-3158], a projected subdivision near Santa Barbara, California, financed by LATD&ME's investors.[46]

As receivership loomed, in accordance with Oliver J. Farrell's instructions, salesmen increased their efforts to secure new deposits without informing investors that LATD&ME had more liquidation requests than it could then honor [R. T. 3172]; that a moratorium had been declared on demands for liquidation [R. T. 3175]; and that trust deeds which had been created against mere grid maps were being confirmed to investors [R. T. 3159].

Oliver J. Farrell's basic sales policy was best stated in his instructions to salesmen not to confuse prospects with lots of facts and details. As he put it, "The more garbage, the more details, the more facts you throw into your sales pitch, the lower your odds of making a sale . . ." [GX 1415].

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[46]Oliver J. Farrell paid nothing for these lots but assumed mortages totaling $5,000 on two of them. Under cross-examination, he attempted to give the impression that all four lots were encumbered, but finally admitted that he had received two lots free and clear. He did develop a horse stable and riding academy, as appellants put it at his "own expense," though this is not strange since profits from this venture were to be his, that is, after he had supplied his brother David with "his choice over a period of years of five foals by any of the mares that I had bred" [R. T. 3155-3158].

The fact that Oliver J. Farrell recognized that he was engaged in a criminal enterprise is evident from his exchange of letters with the Northern California regional manager, set out in the margin.[47]

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[47]Frank Stark to Oliver J. Farrell—October 14, 1959 [GX 1449]:

"Due to our vast and continued expansion, which I feel sure we will enjoy in the future, I believe the time has come when additional sales help and training of our new and older customer representatives would be beneficial. I would like to make the following suggestions:

1. Moving pictures of carefully planned sales talks. These could be sent to each office along with the moving picture projector.
2. Slides on different phases of our type of investment, which can be used by various men in each office in the same manner for training purposes.
3. A sales manual made up after careful study for distribution to the different offices.

All of these would be extremely helpful. I would appreciate your giving serious thought and consideration to the above . . ."

Oliver J. Farrell to Frank Stark—October 15, 1959 [GX 1449]:

"With reference to your memo of October 14, 1959, subject as above, I concur with you that continued training programs are essential even for the older men . . .

"Motion pictures, slides and sales manuals would be very helpful, not only to the branch managers and salesmen, but perhaps also to the SEC, Corporation Commissioner, and Real Estate Commissioner. In fact, they could also be very helpful to our competitors if they got into the wrong hands. These are tangible items which can be supoenaed [sic], you know."

VI.
SUMMARY OF ARGUMENT.

The appellants in effect have conceded the sufficiency of the evidence as establishing a scheme and conspiracy to defraud. None of the areas of error asserted by appellants is of sufficient merit to require more than summary consideration by this court. The evidence of appellants' guilt as shown by the trial record is mountainous. If procedural errors were committed, they resulted in an advantage and not a disadvantage to appellants. The trial court's charge to the jury was an impeccable statement of the applicable law and no conceivable disadvantage to appellants could have flowed therefrom. If any error occurred in the admission of evidence, such evidence was merely cumulative and not prejudicial, and was invited by appellants, who not only did not interpose any proper objection, but also invited any such error by deliberately failing to bring the situation to the attention of the trial court.

VII.
ARGUMENT.

A. The Court's Charge to the Jury as to the Securities Counts Was an Entirely Fair and Proper Statement of the Law of This Case.

1. The "Notes" or "Evidences of Indebtedness" Offered the Public Under the Secured 10% Earnings Program Were Securities as That Term Is Defined in the Securities Act of 1933.

The Secured 10% Earnings Program constituted a medium for more than a simple sale of a second trust deed — an interest in real property; what was really offered by LATD&ME to the investing public were "notes," "evidences of indebtedness" and "investment contracts" as those terms are used in Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1). The appellants' contention that the trust deed obligations are not securities in the form of "notes" or other "evidences of indebtedness" is simply not supported by the case law.

In *Llanos v. United States,* 206 F. 2d 852 (9th Cir. 1953), *certiorari denied* 346 U. S. 923 (1954), the defendants devised a scheme whereby they gave their own promissory notes to obtain money for their own use by making various false representations about their business connections and about the use to which the money was to be put.[48] This court had before it the question

[48]The misleading and illusory quality of the "mutual agreement" obligations in *Llanos, supra,* has a definite resemblance to the legal quality of the trust deed notes, as interpreted by appellants, which were sold under the Secured 10% Earnings Program.

of whether promissory notes were securities within the meaning of Section 2(1) of the Securities Act, that section providing in pertinent part as follows:

> "The term securities means any note . . . evidence of indebtedness . . . investment contract . . . or in general any interest or instrument commonly known as a 'security'."

The appellants, in *Llanos,* contended that the last clause of the above-quoted section, ". . . any interest or instrument commonly known as a 'security' . . ." limits those which come before, and cited many cases which held that promissory notes were not "securities" under other statutes. This court, in holding that the promissory notes were securities, put to rest appellants' contention by stating at 854:

> ". . . These cases involved the interpretation of the word 'securities' as used in particular acts and did not involve the definition of 'security' given in the above statute. In defining the word 'security' in Section 2(1) of the Act, Congress intended to include all interstate transactions which were the legitimate subject of its regulation and the section should not be construed narrowly. . . ."

In addition, this court held the instruments were clearly "evidence[s] of indebtedness" and as such fell within the statutory definition of securities, citing *United States v. Monjar,* 147 F. 2d 916, 920 (3rd Cir. 1945), *certiorari denied* 325 U. S. 859; also see 4 Duke B. J. 52 (1954).

In *United States v. Monjar, supra,* appellants were indicted for violations of Section 17(a)(1) of the Se-

curities Act of 1933 and mail fraud, in connection with a scheme to defraud involving the solicitation of "personal loans", evidenced by receipts, entitled PLs and CDs. The trial court, citing *S. E. C. v. Universal Service Association,* 106 F. 2d 232, 235 (7th Cir. 1939), *certiorari denied,* 308 U. S. 622 (1940), had held the receipts to be securities:

> "Each person making a loan received a receipt signed by the person accepting the loan as 'agent' and making reference to 'H.B.M.-PL' or 'H.B.M.—Personal Loan.' The receipts were the only evidence that defendant Monjar had borrowed money. *Those dissatisfied with the arrangement were to be allowed a refund of the amount advanced as shown by the receipts. To this extent, the receipts certainly fall within the category of an 'evidence of indebtedness' as that term is used in Section 2(1) of the Statute.* Again, the indictment charges that the money received from the loans would be used 'to organize business concerns which would operate for the benefit of the persons making the loans.' The money was paid over by the members who made the 'PL' and 'CD' loans with the expectation that the return to be obtained would give to 'worthy men' financial independence. Under such an arrangement, the receipts issued to those making the loans likewise come within the definition of an 'investment contract'." [Emphasis added]. 47 F. Supp. 421, 427 (D. Del. 1942).

The Court of Appeals affirmed, holding that the indictment sufficiently described the securities in the language of the statute as "evidences of indebtedness".

See also:

S. E. C. v. Vanco, Inc., 166 F. Supp. 422 (D. N. J. 1958), aff'd 283 F. 2d 304 (3rd Cir. 1960).

The record before this court is compelling that LATD&ME offered the public "notes" and "evidences of indebtedness" under their Secured 10% Earnings Program. The thousands of investors who were brought into the Secured 10% Earnings Program were assured that they were receving negotiable promissory notes [GX 1901-1932]; that their deposits with LATD&ME were like deposits with a bank [R. T. 1024; 1108; 1156; 1845; 1907-1909]; and *that the "estimated liquidation value"* shown on their monthly statements evidenced LATD&ME's indebtedness to them which was due and payable whenever they elected to withdraw their accounts [R. T. 775; 1801; 1930]. Investors were also assured that LATD&ME would honor liquidation requests, without delay [R. T. 1419; 1845; 1890].

The argument that the instruments were not "notes" and "evidences of indebtedness" *within* the meaning of the statute is demolished by the instruments themselves.[49] They are by their very terms unconditional and unqualified obligations of the makers. They were so described by the appellants in the brochures sent to investors. The brochures, for example, described the notes as "negotiable notes" and referred to the careful screening made of the credit standing of the makers of the obligations [*e.g.,* GX 843]. There is not a line of evidence in the record that the appellants made any disclosure what-

[49]A typical such note is set out in Appendix F.

soever to any investor, whether a resident of California or a soldier stationed in Korea, that the "straw" corporations manufacturing the obligations that went into investors' accounts contended that they were shielded against liability under California law. This, of course, was simply another element of the scheme to defraud. Therefore, if the nature and quality of the instruments are to be judged by what they "were represented to be", *S. E. C. v. Joiner Leasing Corporation,* 320 U. S. 344, 353 (1943), the instruments must be classified as securities.

The appellants contend that *under California law* the promissory notes and other trust deed obligations which were sold to investors represent "purchase money obligations" which are not enforceable against the makers or trustors, except to the extent of the realizable value of the units of land securing the obligations. Thus, they assert that, as the trustor or obligor is not subject to personal liability or to deficiency judgment, in the event upon foreclosure the security proves to be inadequate, the instrument is not a "note" and is not an "evidence of indebtedness."

Initially it should be noted that federal law and not California law determines whether or not instruments are securities under Section 2(1) of the Securities Act of 1933.

> *Los Angeles Trust Deed and Mortgage Exchange v. S.E.C.,* 264 F. 2d 199, 211 (9th Cir. 1959);
>
> *S.E.C. v. Variable Annuity Life Insurance Co. of America,* 359 U. S. 65, 69 (1959).

Under federal law, as the Supreme Court has said,

> *"The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."* (Emphasis added.)
>
> *S.E.C. v. C. M. Joiner Leasing Corp.,* 320 U. S. 344, 352-353 (1943).

Even if California law were in some way relevant, the holdings in appellants' cited cases are not in the slightest compelling on a factual situation such as presented in the case at bar. In fact, in *People v. Davenport,* 13 Cal. 2d 681 (1939) cited by appellants, the court states at 684:

> ". . . the mere fact that a transaction is clothed in the language and form of . . . [a purchase money situation] is not in itself a conclusive badge of its innocence. In proper circumstances 'courts have looked through form to substance . . .' "

Appellants disregard entirely the true nature of the trust deed notes created under the Secured 10% Earnings Program, in relying upon Section 580b of the California Code of Civil Procedure as establishing that, as "purchase money obligations," the instruments are not enforceable against the obligors except to the extent of the value of the land securing the obligations. This argument assumes that, under California law, the courts would hold that the thousands of trust deed obligations manufactured at the instance of appellants by

"straw" corporations controlled by appellants and real estate speculators, pursuant to a deliberate scheme to establish unrealistic and illusory *face values* as a means of defrauding investors, are true "purchase money obligations." In *Roseleaf Corporation v. Chierighino,* 59 A. C. A. 45, 52 (1963), the Supreme Court of California stated that Section 580b of the California Code of Civil Procedure [Appendix N] was intended to put on the vendor the risk of accepting inadequate security for a purchase money obligation, as a means of discouraging overvaluation, noting that ". . . Precarious land promotion schemes are discouraged, for the security value of the land gives purchasers a clue as to its true market value."

2. The Jury Was Properly Instructed in This Matter.

The court's instructions to the jury, whether considered separately or as a totality, were impeccable statements of the law of the case. If the trial court erred, it did so to the advantage of the appellants and not the government. This is how it should be. The court did not, as suggested by appellants, withdraw from consideration of and determination by the jury, any fact, disputed or otherwise.

The reliance by appellants *Roe v. United States,* 287 F. 2d 435 (5 Cir. 1961) is misplaced. In *Roe v. United States,* it was held that the trial court had invaded the province of the jury by instructing them that the instruments involved were "investment contracts" and therefore securities. In the instant case the court below repeatedly admonished the jury, in unmistakable terms, that in weighing the guilt or innocence of the defendants under the Securities Act counts,

the jury, themselves, must arrive at a factual determination whether the instruments involved were securities within any of the statutory definitions which the Government contended were applicable.[49a]

The appellants, of course, sought to confine the instruction to the single question of whether the Secured 10% Earnings Program involved the issuance and sale of "investment contracts," within the statutory definition. The court below correctly ruled that the government should not be so circumscribed in its presentation; and that if, as alleged in the indictment, the jury made the determination from the evidence that the instruments the appellants were selling were "notes" or "evidences of indebtedness" or "investment contracts" within the statutory definition, then that element of the offense was satisfied.

There is no ambiguity or uncertainty in the definition of "security" as including the type "note" or "evidence of indebtedness" involved in this case. As the Supreme Court has said in determining whether an instrument is a security, it is unnecessary to do anything "to the words of the Act; [but] merely accept them." The Court continued by stating instruments could be proved to be securities under the Act by "proving the document itself, which on its face would be a *note,* a bond, or a share of stock" while in other instances "proof must go outside the instrument itself. . . ." (Emphasis added.) *S. E. C. v. Joiner Leasing Corporation, supra,* at 355.

[49a]The court's instructions on this issue [R. T. 4266-4274] are set out in Appendix O.

See also:

United States v. Corbett, 215 U. S. 233, 242, 30 S. Ct. 81, 54 L. Ed. 173, 175 (1909);

Donnelly v. United States, 276 U. S. 505, 512, 48 S. Ct. 400, 72 L. Ed. 676, 678 (1928);

United States v. Giles, 300 U. S. 41, 48, 57 S. Ct. 340, 81 L. Ed. 493 (1937).

B. The Evidence Concerning the Civil Litigation Between the Securities and Exchange Commission and Los Angeles Trust Deed & Mortgage Exchange Was Properly Admitted.

The grand jury charged in the indictment in the instant matter that the appellants concealed from investors the true nature of the civil litigation, i.e. that the litigation was not solely a jurisdictional dispute but involved charges of fraud and insolvency. The government's position was and is that regardless of the truth or falsity of the charges, an LATD&ME investor, prior to depositing his money with the firm was entitled to have knowledge of the actual allegations, so that he could make suitable inquiry before entrusting his savings to LATD&ME.

The trial court recognized that the government was entitled to establish as an element of the scheme to defraud, appellants' callous course of conduct in continuing to ensnare investors while concealing and misrepresenting the true nature of the civil litigation.[50]

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[50]The court pointed out:

". . . I feel . . . that the offers of the pleadings and the Answer, and of the time the decree was entered would be relevant and material on the question of good faith.

Now, on the other hand, I recognize that there is material in the pleadings and there is material in that order which on

The court, however, rather than allow the government to refer to or introduce into evidence copies of the civil pleadings, decided upon a procedure which was much more generous to appellants than the situation demanded. The court gave the jury a brief summary of the civil litigation in the most innocuous manner. [R. T. 3026-3029.][51]

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the face of it is—let's say it will be highly prejudicial if it wasn't relevant and material. But, of course, we have those problems in trials of lawsuits, where material may be highly prejudicial, and still if it contains something that is relevant the court has no alternative but to admit it and then try to instruct it out." [R. T. 2872].

[51]"The Court: Members of the jury, in lieu of the acceptance in evidence of Exhibits 1950, 5200, 5201 and 1950-A, I will give you a summary of some of the facts in such exhibits which I deem of possible relevance or materiality for your consideration.

On March 24, 1958, the Securities & Exchange Commission filed a Complaint against Los Angeles Trust Deed and Mortgage Exchange, Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Markets, David Farrell, Oliver J. Farrell, Roy A. Bonner, and Thomas Wolfe, Jr., charging the defendants with violation of certain Sections of the Securities Exchange Act, including charges that defendants were engaged in transactions, practices and a course of business which operated and would operate as a fraud and deceit upon purchasers of such alleged securities.

On October 8th, 1958, the Commission filed an Amended and Supplemental Complaint charging the corporate defendants with misappropriation of funds entrusted to them by investors under the Secured 10% Earnings Program, and further charged that said corporate defendants were insolvent and unable to meet their current obligations. The Amended Complaint included as a party defendant Stanley C. Marks.

The charges in both the original and the Amended and Supplemental Complaint were denied by the defendants.

On May 20, 1960, a judgment was entered in said proceedings permanently enjoining the defendants from engaging in the acts as charged. The effect, however, of this injunction was stayed—that is, put off—by an appeal.

Pursuant to the judgment the Receiver took charge of the assets and business of the corporate defendants on June 8, 1960.

Now, neither the charges made in the pleadings in such case nor said judgment are to be considered by you as evidence of the truth of such charges. The above statement of facts is given to you solely in connection with your consideration of the charges

While appellants now assert as error this act of judicial beneficence, it was the appellants who chose to cover up, to conceal, and to misrepresent the civil litigation. They chose to solicit and accept millions of dollars from investors under such conditions of concealment and affirmative misrepresentation. They were wrong. As the trial judge said in referring to the obvious relevance of the prior litigation:

> ". . . no mater how bloody the corpse, if it is relevant and material, the State is entitled to try its case to the hilt." [R. T. 342].[51a]

Appellants' cited case of *Monte Green v. State of Indiana,* 204 Ind. 349 (1933), 184 N. E. 183, is not applicable to the situation at bar. In the *Green* case, the decisive issue to be determined at the criminal trial was whether the bank was insolvent at the time that officers of the bank received a certain deposit. The prosecution introduced the record of a prior civil proceeding in which it had been determined that the bank was insolvent. The Appellate Court held the admission of the record was error because:

1. There was a difference between civil insolvency and criminal insolvency;
2. The introduction of the evidence would in fact determine the issue of insolvency in the minds of the jury;

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made in Paragraph 11, Count one, of the indictment." (After the jury retired from the courtroom, during the recess, the court pointed out, ". . . I have adopted this procedure, for better or for worse, and in line with what I think is the essential justice of the offer, and what I have said contains the relevant and material matter which should be submitted.") [R. T. 3026-3029]. (Emphasis added.)

[51a]Statement by Court during pre-trial proceedings.

3. The admitting of the testimony would in fact deprive the defendant of the right of cross-examination.

In the instant situation, the court's summary of the civil litigation was introduced *solely* to show there had been in fact a civil proceeding in progress and not as evidence of the truth of the charges. In addition, members of the jury were specifically instructed *not* to consider any determination made in the civil proceeding in determining the guilt or innocence of the accused.

Implicit in the rule that a civil judgment is not admissible in a criminal case is the difference in the quantity of proof necessary to prove criminal charges. This principle, however, is not applicable where the fact of the civil proceeding is *not* received as evidence of any disputed fact which was adjudicated in the civil proceeding. Such is the situation in the case at bar where the material in question (summary of prior proceedings), was not introduced to establish the appellants were guilty of fraud, but only that certain allegations had been made, without regard to their truth or falsity.

State v. Morris, 109 Wash. 490 (1920), 187 Pac. 350 (1920);

Krull v. United States, 240 F. 2d 122 (5th Cir. 1957), *certiorari denied* 353 U. S. 915.

C. The Appellants Were Not Prejudiced by Evidence Concerning Losses by Investors or Occurrences Subsequent to the Receivership Established for Los Angeles Trust Deed & Mortgage Exchange.

The appellants contend that, as the government was not required to allege or show that anyone was defrauded or that investors lost money [*Bobbroff v. United States,* 202 F. 2d 389 (9th Cir. 1953)], evidence to that effect should not have been received. While not required to allege or prove the success of a scheme to defraud or that losses resulted as an element necessary to sustain a conviction, the government not only may but usually does introduce such evidence in securities and mail fraud prosecutions. *Rice v. United States,* 35 F. 2d 689, 695 (2nd Cir. 1929), *certiorari denied,* 281 U. S. 730 (1930); *Lonergan v. United States,* 95 F. 2d 642, 646 (9th Cir. 1938), *certiorari denied,* 304 U. S. 581; *Lemon v. United States,* 278 F. 2d 369, 373 (9th Cir. 1960). In *Linden v. United States,* 254 F. 2d 560, 566 (4th Cir. 1958), the court held:

> "Proof that the scheme was effective should not be excluded as irrelevant. While it is true that the success of a scheme is not a necessary element of the crime defined in the Mail Fraud statute, nevertheless where, as here, the indictment charges the defendant with making captious, deceptive, and misleading solicitations, the effect of the solicitations upon the recipients is a highly pertinent fact in determining whether the solicitations are of the nature charged. . . . *The tendency of the form to mislead is shown by testimony that it did mislead.*"

In *United States v. Brown,* 79 F. 2d 321, 324 (2nd Cir. 1935), *certiorari denied sub. nom., McCarthy v. United States,* 296 U. S. 650, Judge L. Hand commented that it had been a custom for over twenty-five years in the Southern District of New York to admit such testimony:

> ". . . it may be relevant to show that after purchase the shares collapsed in value, on the theory that this helps to prove that they had no value when the accused recommended them . . ."

The appellants also contend that testimony of losses was inadmissible as the losses were realized after the business was removed from their control. The government, however, is entitled to introduce evidence of events occurring after receivership if those events tend to establish the falsity of representations made by the defendants. *Kaufmann v. United States,* 282 Fed. 776, 781-782 (3rd Cir. 1922), *certiorari denied,* 260 U. S. 735; *Neubauer v. United States,* 250 F. 2d 838, 841-842 (8th Cir. 1958), *certiorari denied,* 356 U. S. 927. The testimony of a receiver of losses which resulted from his effort to dispose of assets and collect debenture bonds has been held to be admissible. *Ridenour v. United States,* 14 F. 2d 888, 891 (3rd Cir. 1926). If the representations made to investors that trust deeds selected for the Secured 10% Earnings Program were of sufficient quality to protect investors, even if LATD&ME ceased to exist, had been true, the receivership would not, and could not have brought about the losses to investors.[52]

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[52]The trial judge repeatedly ruled that the basis of his allowing testimony by investors of losses was that such evidence was rele-

The admission of evidence of losses by investors in no way prejudiced the appellants. The court allowed appellants to call as witnesses, eleven supposedly satisfied investors to testify that LATD&ME honored their liquidation requests [R. T. 3257; 3284; 3290; 3302; 3305-3306; 3380; 3387; 3569-3570; 3576], and that they received monthly "earnings" checks [R. T. 3257; 3285; 3561-3562]. The appellants were also allowed to cross-examine investor witnesses called by the government to establish that they never requested the return of their funds from LATD&ME [R. T. 1802-1803; 1934; 1984; 2183; 2283], and that they received monthly "earnings" checks until the time the receiver took over [R. T. 1969; 2024-2025; 2282].

Appellants received an additional safeguard when the trial court charged the jury:

> "You shall disregard any evidence or testimony *of any customer of* Los Angeles Trust Deed & Mortgage Exchange and affiliated companies to the effect that a loss was suffered after June 7, 1960. The defendants are not charged with responsibility for acts occurring after that date." [R. T. 4304.] (Emphasis added.)

Appellants' present claim that the words *of any customer of* [LATD&ME] were omitted from the trial court's charge to the jury is not well founded.[53]

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vant and material in establishing the quality of the trust deeds and the financial condition of LATD&ME prior to receivership [R. T. 1493, 1516-1517; 1540-1542]. Moreover, this evidence was merely cumulative of other uncontradicted evidence showing the grossly inflated value of the trust deeds, and LATD&ME's insolvency.

[53]See Appendix P establishing that the court reporter inadvertently omitted the underscored words from the reporter's tran-

In addition, it should be noted that appellants never objected to the charge given by the district court [Brief, DF, p. 37] and never submitted any proposed instructions of their own [C. T. 469-498]. It is now too late to claim "prejudice" so severe as to cause a reversal of appellants' conviction.[54]

D. There Was No Staging of Investor Witnesses Intended to Inflame the Jury Against Appellants.

The "cutting edge of the government's case" was not, as contended by appellants [Brief DF, pp. 33-38] the selection of investor witnesses whose age, infirmities, lack of formal education, or financial distress was intended to arouse hostility against appellants and inflame the jury against them. The true "cutting edge" was the cumulative and indeed crushing weight of the evidence, much of it consisting of the internal records of LATD&ME and its affiliates, showing a cleverly designed, ingeniously plotted scheme and conspiracy to ensnare investors, which the appellants pursued until the very moment when on June 8, 1960, in accordance with the order of this court denying a stay of the receivership, their criminal conduct was interrupted. This was no "finely balanced" case as the appellants contend [Brief DF, p. 47]. The "glut of

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script though the underscored words are to be found in his shorthand notes taken when the court charged the jury.

[54]Rule 30, Federal Rules of Criminal Procedure, provides, in part:

> ". . . No party may assign as error any portion of the charge or omission therefrom unless he objects thereto before the jury retires to consider its verdict, stating distinctly the matter to which he objects and the grounds of his objection . . ."

documentation," mentioned by appellants [Brief DF, p. 16], standing alone, established the existence of a cruel and heartless enterprise designed to defraud investors and enrich the appellants.

There was no staging of selected investor witnesses whose situations, when brought before the jury, were intended to "engender sympathy for the alleged victims and conversely antipathy against the [appellants]" [Brief DF, p. 34]; except to the extent that the submission of testimony of a reasonably balanced cross-section of the some 10,000 investors under the Secured 10% Earnings Program may have given the jury, as it was intended to do, a true insight into the scope, extent and essential quality of the scheme to defraud. The government not only called as investor-witnesses Mr. Lees [R. T. 1806], 69 years of age, with impaired hearing and unemployed; Mr. Campbell [R. T. 1842, 1847], 87 years of age, whose wife was in the hospital; Mr. Schanz [R. T. 1866-1867], 72 years of age, with impaired hearing; Mrs. Hlavka [R. T. 1789], a widow; and Mrs. Eppley [R. T. 719], a 72 year old widow; but also brought forward Mr. West [R. T. 2185, 2206], a 35 year old real estate broker and real estate appraiser; Mr. Broome [R. T. 1103-1104], a 44 year old salesman; Mr. Youngs [R. T. 1833-1834], 53 years of age, in the heat treating business; Mr. Freedman [R. T. 1405], a TV writer, who collaborates with his wife in writing novels; Mr. List [R. T. 1886], a school teacher, whose wife is a pharmacist; and Mr. Ray [R. T. 1526-1527], 67 years of age, who retired in 1957 after selling a printing business which he had owned for 30 years.

Moreover, of the 27 investors named as "count witnesses" in the securities and mail fraud counts, the government used only 19. Likewise, of the 15 investor-witnesses named in the conspiracy count, the government used only 10. The evidence as to transactions between LATD&ME and the remaining 8 investor "count witnesses", and the 5 conspiracy count investor-witnesses, consisting of records of LATD&ME, including correspondence with those investors, was introduced by stipulation and without objection.

The record is barren of any instance in which the defense objected to the testimony of any investor witness on the ground that the government was endeavoring to elicit irrelevant testimony concerning the age, marital status, health, financial status or other condition which might have been disallowed or restricted by the trial judge in his discretion. The appellants concede this to be so, and admit that the argument, which they anticipate, that such objections were waived, is perhaps well taken [Brief DF, p. 34]. However, they seek refuge in a reference to Judge Frank's observation [Brief DF, p. 34] that the government should not put defense counsel in the dilemma where "as experienced trial lawyers have often observed, merely to raise an objection to such testimony—and more, to have the judge tell the jury to ignore it—often serves but to rub it in," *United States v. Grayson,* 166 F. 2d 863, 871 (2d Cir. 1948).

Counsel for the defense were caught up in no such dilemma at any time during the course of the trial. The trial judge made it abundantly clear in his last pre-trial order [C. T. 290-292] that elaboration of all objections

was to be made during recesses and outside the presence of the jury. This salutary ruling was strictly observed. A portion of nearly every recess was taken up by the court in considering arguments and objections concerning matters which had arisen in the course of the proceedings.

Where doubt existed as to the propriety of any area of interrogation, the court repeatedly directed counsel for the government to proceed in a new direction until further argument could be heard in the absence of the jury [*e.g.,* R. T. 1492; 1506; 2040].

In *United States v. Brown,* 79 F. 2d 321, 324 (2nd Cir. 1935), *certiorari denied,* 296 U. S. 650, cited by Judge Frank in a footnote to his concurring opinion in *United States v. Grayson, supra,* at 870, the court rebuked the conduct of the government in "getting before the jury that in consequence of their losses some buyers had lost their homes and their business, and gone hopelessly into debt; that they lost everything including their friends, and were destitute; that their losses went into millions; that one unfortunate had committed suicide," but nevertheless, affirmed the mail fraud conviction in the light of the irrefragable showing of guilt of the accused. The court noted that it *had* "never given warrant to any such abuse" but had given sanction to ". . . evidence that the property bought turned out to be worthless, or that it greatly fell in value."

As Judge L. Hand said in *Grayson v. United States, supra,* at 867, ". . . it is never a ground of objection to evidence directly relevant to the crime that it exposes the accused to odium, or even implicates him

in another crime . . . It is true that a judge has discretion to rule out even relevant evidence if it is not cogent and is more likely to distract, than to inform, the jury; but that cannot be said of the very communications between the accused and his victims. So far as these incidentally arouse the hostility of the jury, he is without relief. . . ."

The statement of Judge Frank in *United States v. Grayson, supra,* at 871, that ". . . a prosecutor ought not deliberately and repeatedly [as he held to have been the case], put defendant's laywer in such an awkward dilemma—where his client will suffer if the lawyer does not object or if he does . . ." is without the slightest relevance to the trial proceedings which resulted in the conviction of these appellants. The trial judge held counsel for the government to the most rigid and exacting standards in the examination of witnesses and otherwise in the conduct of the trial. He frequently admonished counsel for the government for even the slightest impropriety [R. T. 1432-1433; 1968-1969; 2040, 2053; 2054-2057], and himself intervened at times, without objection having been made by defense counsel, when he considered that the examination by government counsel might be exceeding permissible limits [R. T. 1431, 1494-1496; 1977-1981; 2004; 2053].

The government is under a heavy obligation in a case such as this, involving intricate and complex financial machinations, intruding upon the lives of many thousands of investors of widely dissimilar circumstances, to lay before the jury the true fabric and structure of the enterprise. This is true notwithstanding the fact

that the proof may expose the accused as having engaged in a sordid and heartless course of conduct. As stated by Judge Bell in *Greenhill v. United States,* 298 F. 2d 405, 411 (5th Cir. 1962), *certiorari denied,* 371 U. S. 830, in affirming convictions for securities and mail fraud:

> "The fact that the government used, without objection based on prejudice, as five out of some twenty investor witnesses one who was blind, and others who were peculiarly objects of sympathy did not deprive appellants of due process of a fair trial. Appellants and not the government made them investors and prospective witnesses."

E. The Trial Court Did Not Commit Error in Admitting Exhibit 6003 Into Evidence.

1. Preliminary Statement.

Exhibit 6003 consists of two baskets containing customer "sell orders" together with their attached covering letters, which documents were a part of LATD&ME's records at the time it went into receivership.[55]

Although appellants now raise several contentions of error in the trial court's admission of Exhibit 6003 into evidence, none of these objections were presented below to provide the trial judge an opportunity to prevent any alleged error.[56] Any "error" which may exist,

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[55]R. T. 2798-2800.

[56]Exhibit 6003 was "admitted" into evidence on two occasions. The first time, during examination of Government witness Cole, appellants objected on the ground of "no proper foundation" [R. T. 2799], a basis not urged in this appeal [Brief DF, pp. 38-49]. Subsequently, during the direct examination of appellant David Farrell, it was discovered that the clerk did not have 6003 marked in evidence, whereupon it was again of-

was invited by appellants as a result of their withholding from the trial court during the trial their knowledge that one letter containing a "newspaper article" reporting Judge Clarke's remarks after the civil trial, and the other "prejudicial" letters were attached to the sell orders comprising Exhibit 6003.[57] Such

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fered by the government, "so that the question can be asked." Appellants made *no* objection [R. T. 4007] and 6003 was again received in evidence.

[57]After the trial, Attorney Dunn filed a Memorandum [C. T. 530] alleging:

> ". . . 6003 had attached to one of the 'sell orders' a highly prejudicial newspaper article concerning the civil trial between SEC and LATD&ME . . ."

At the time of the hearing of appellants' motions for judgment of acquittal, some three weeks after the trial, the court expressed concern as to when Mr. Dunn first became aware of the newspaper article. Mr. Dunn said that it had been brought to his attention on the morning of arguments, after discovery by O. J. Farrell [R. T. 4360]; then amended this comment by saying he did not find out about the article until the documents were in the jury's possession [R. T. 4361]. Subsequently, Mr. Dunn produced a note which he had received from O. J. Farrell during the time the jury had come in for some questions, which note was dated 4/16/62 at 4:55 p.m., and initialed by O.J.F. and Mr. Dunn himself. The note read:

> "I think the Government sneaked Judge Clarke's press release into evidence with the sell orders" [R. T. 4369-4370].

Attorney Holder, who had filed a declaration [C. T. 525] admitting:

> ". . . During the trial I examined a random sample of the sell orders contained in Exhibit 6003; because of the pressure of time the two boxes of sell orders were not carefully examined."

told the court at the hearing, that he personally was unaware during the trial, of the "press clipping," but that after the trial, O. J. Farrell had told him he "thought he saw a clipping in there." Mr. Holder then looked through 6003, for the article, and found it. In answer to the court's question: "And Mr. O. J. Farrell then knew that during the time that the trial was going on?" Mr. Holder responded, "I asume he did. I don't know. . . ."

objections may not be urged for the first time on appeal absent a showing of "plain error."[58]

Appellants were not surprised by an unexpected government offer of Exhibit 6003, nor did government counsel misrepresent its intended use of the exhibit.[59] Nor is the allegation that the government failed to conform to the order of the court to excise certain "prejudicial" material from 6003 supported by their transcript reference [Brief DF, p. 42].[60]

Irrespective of the foregoing, it is submitted that 6003 was properly admitted as a part of the business records of LATD&ME.

Finally, if there was error in the admission of the exhibit it was but "harmless error." The one "newspaper article" mentioned by appellants has received emphasis beyond deserved proportion. It was but a single attachment, doubled over and stapled to its accompanying "Customer sell order," selected by appellants out of the more than 800 sell orders. (The others contain no such

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[58]See:

Olender v. United States, 237 F. 2d 859, 866 (9th Cir. 1956), *certiorari denied* 352 U. S. 982 (1957);

Sekinoff v. United States, 283 Fed. 38, 39 (9th Cir. 1922);

Finnegan v. United States, 204 F. 2d 105, 111 (8th Cir. 1953), *certiorari denied* 346 U. S. 821 (1953).

[59]See argument, *infra.*

[60]The reference in the third paragraph of the transcript portion quoted by appellants [*i.e.* at R. T. 3043-3044] clearly speaks of those documents which have been "provisionally admitted." This term was used by the court to describe those documents and ledgers which had been offered by the government and specifically objected to because of lack of authentication of certain notations [see R. T. 3041, lines 13-24]. This question was never raised *re*: Exhibit 6003, and the quoted portion had nothing whatsoever to do with that exhibit.

attachment.) No showing has been made that the jury inspected any of the contents of Exhibit 6003, let alone that they found this specific document; or any of the other letters now questioned as being "prejudicial."[61] Further, even if the "article" or the contents of other letters had been seen, their content, was at most merely cumulative of the other evidence in the trial, and did not prejudice or affect the substantial rights of appellant.[62]

2. Appellants' Contentions of Error May Not Be Raised for the First Time on Appeal.

(a) *Appellants' Sole Objection at the Trial, to the Admission of Exhibit 6003, Was on the Ground of "No Proper Foundation"; and They May Not Urge New Objections for the First Time on Appeal.*

Appellants' argument[63] attacking the admission of Exhibit 6003 into evidence contains numerous contentions of error,[64] none of which were even suggested to the

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[61]See:

Carlson v. United States, 187 F. 2d 366 (10th Cir. 1951), *certiorari denied* 341 U. S. 940 (1951).

[62]See:

Gilbert v. United States, 307 F. 2d 322 (9th Cir. 1962);
United States v. Quong, 303 F. 2d 499, 504 (6th Cir. 1962);
Gordon v. United States, 164 F. 2d 855, 858 (6th Cir. 1947), *certiorari denied,* 333 U. S. 862 (1948);
Finnegan v. United States, 204 F. 2d 105 (8th Cir. 1953), *certiorari denied* 346 U. S. 821 (1953).

[63]See Brief DF, pp. 38-49.

[64]Appellants have failed to comply with Rule 18, Rules of the United States Court of Appeals for the Ninth Circuit, which provides:

". . . When the error alleged is to the admission or rejection of evidence the specification shall quote the grounds urged at the trial for the objection and the full substance of the evidence admitted or rejected, and refer to the page number in the printed or typewritten transcript where the same may be found. . . ."

trial court. At one time appellants did question the relevancy, competency, materiality and the lack of proper foundation of Exhibit 6003. The court at the time sustained their objection [R. T. 2795-2796]. Subsequently, when the foundation was laid and Exhibit 6003 was again offered, appellants limited their objection to "no proper foundation," abandoning the objections of lack of relevancy, materiality or competency. Counsel for David Farrell amplified his single objection in the following manner:

> "Your Honor, we object to it on the ground that there is no proper foundation. Especially in looking at 6002, and the dates, apparently, that are put on here they are all late in June, or June 6th and 7th, and certainly would not be admissible in that regard *unless there was a foundation as to the time the requests were received.*" [R. T. 2798-2799]. (Emphasis added).

The Court satisfied itself that the proper ". . . foundation as to . . . time . . ." had been laid by asking the witness Leroy Cole, who had supervised the inventory audit of LATD&ME:

> "Were these requests part of the books of the company when you went to make the audit at the time you assisted in taking over? Were they in the possession of the company at that time?"

The witness answered that "They were in the possession of the company", whereupon the court overruled this sole objection [R. T. 2799].

These claims of error then, including those of hearsay, surprise and improprieties on the part of the gov-

ernment, are matters being presented to this court for original determination.

Rule 51 of the Federal Rules of Criminal Procedure requires that in order to preserve a question for appeal:

> ". . . it is sufficient that a party, at the time the ruling or order of the court is made or sought . . . makes known to the court the action which he desires the court to take or his objection to the action of the court and the grounds therefor . . ."

Objections to the admission of records and documents, not having been made before the trial court, cannot be urged here as reversible error.

> *Olender v. United States,* 237 F. 2d 859, 866 (9th Cir. 1956), *certiorari denied* 352 U. S. 982 (1957).
>
> *Sekinoff v. United States,* 283 Fed. 38 (9th Cir. 1922),

(b) *Appellants "Invited the Error" of Which They Now Complain, by Their Failure to Apprise the Trial Court of Their Knowledge of the Alleged "Prejudicial" Material in Exhibit 6003.*

The documents filed by Attorneys Dunn and Holder, as well as their respective statements at the hearing on Appellants' Motions for Judgment of Acquittal, after the trial, clearly reveal that counsel and their clients had opportunity to, and did examine Exhibit 6003 and were aware of the "newspaper article" and other al-

leged prejudicial documents, during the course of the trial.[66]

Liquidation requests made by investors during the month of May and the first week of June, 1960 were recognized as material and relevant to the issues of the case by Attorney Holder and his client Oliver J. Farrell. Appellant Farrell stated that during May, 1960 ". . . a number of customers were waiting for the liquidation of their accounts . . ." [R. T. 3106]. On cross-examination he admitted that at the time they were increasing the sales campaign in May, 1960 ". . . [he] knew that the company had more liquidation requests than it was able to process immediately" [R. T. 3172]; that they came in from a substantial number of investors, perhaps several hundred; that the amount of money needed was ". . . in the high thousands . . ."; and that a mortorium had been declared on any investor requests to receive their money back [R. T. 3172-3175].

David Farrell also expressed complete familiarity with the problem of liquidation requests during his direct examination by Attorney Dunn, both generally and specifically regarding the contents of Exhibit 6003.[67]

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[66]See Footnote 57, *supra*.

[67]R. T. 4008—"Q. by Mr. Dunn: Mr. Farrell have you examined 6003? A. No, I have not examined it. I can tell by looking at it what it consists of.

Q. All right. Will you state what it consists of? A. It consists of some orders received by the company during this

The very documents contained in Exhibit 6003 themselves, patently indicate that both appellants David and Oliver J. Farrell, in their respective positions as President and Vice President-Sales Manager, knew before the trial ever began, the manner in which the sell orders were being used, how they were coming in, the types of documents which were attached to the sell orders, and what the company's procedure was in handling these sell orders.[68]

Appellants' statement in their appendix regarding letters containing ". . . a reference to Judge Clarke's statement"[69] is misleading. The reference pertained to a "form letter"[70] which is to be distinguished from

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period in question which had not been processed as of the June 8, 1960, date when the receiver took over.

Q. You are referring to the period of May and early June 1960? A. Yes; from May to June 1960. These are the remaining ones other than the ones we processed."

[68]At least 45 of the sell orders, or the letter attachments thereto, bear the initials "OJF," indicating that O. J. Farrell had reviewed those sell orders and their stapled covering letters. (*E.g.,* Sell Orders for Account Numbers: 768, 786, 841, 1063, 1231, 504, 3154, 3251, 3261, 3481, 3885, 5031, 7202, 7338, 1677, 1691, 2386, 7839, 6909 and numerous others. On the bottom of the letters attached to 20449, it is noted "O.J. would not ok for Rush 5-31-60." Nor is it surprising that these documents were reviewed by Oliver J. Farrell, in that he was the man responsible for the sales activities of all the branches of the company [R. T. 3097] and to whom all sales managers of the various branches were answerable [R. T. 3114].

Forty-six sell orders bear the name "O. J. Farrell" typed in the space apparently reserved for the name of the salesman for that specific investor. (*E.g.,* Account Numbers: 295, 401, 458, 5818, 7173, 20175, 20317, 20394, 20455, 20850, etc.)

David Farrell's name also appears on several other sell orders: (Account Numbers: 20228, 20229, 20380, 20449).

[69]See for example the reference to the letter of Joseph Pearson No. 4703, Brief, O.F. Appendix p. 21.

[70]"..... 1960.

"Recent articles in the newspapers quoting statements made by Federal Judge Thurmond Clarke concerning SEC

the stapled copy of the "newspaper article", which was but one of over 800 documents found in Exhibit 6003.

The record shows that this "form letter" was prepared by appellants and sent by them to investors who were planning to close out their account. Appellants, through their "form letter" attempted to solicit information from investors regarding whether or not their planned liquidation was based on "adverse publicity". This "form" used in a manner which invited its return with the sell order, is now claimed to be "prejudicial."[71] Appellants were trying to document for future use, that investors closed out their accounts because of

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hearings in the District Court, caused me to lose confidence in the Los Angeles Trust Deed and Mortgage Exchange, and to request the liquidation of my trust deeds as soon as possible. This is the sole reason for this request and nothing the Exchange has said or done has caused me to have any doubts or complaints.

.....

....."

[71] *E.g.*, Customer Sell Order for account No. 3134 for customers J. C. and Norma B. Greer, has as an attachment, an office memorandum and a small 3"x4" typed note, which says:

"Dear Mrs. Greer:

"If you are with-drawing your funds for the reasons specified on this form, will you please sign it also, and return it with the customer Sell Order? Thank you."

This note is stapled to an unsigned form, wherein a small "x" had been indicated at the place for the signatures of the Greers. The customer wrote on the form at the bottom "No, I am being transferred to the East coast. James C. Greer.", and did not sign the form where indicated.

No. 9132—Customer Sanders: Attached to the Sell Order is a copy of the form letter, wherein after the first words in the first sentence "Recent Articles in the newspapers quoting statements . . .", the word "allegedly" is interlineated into the sentence. Also attached to the Sell Order and to the form letter is a letter on the TD&ME Letterhead addressed to Mr. O. J. Farrell from G. K. Sloan, which letter reads in part as follows:

"Dear O.J.

Re: *Liquidation Senders No. 09132.*

Enclosed is a Customer's Sell Order re: the above noted

the alleged adverse publicity stimulated by Judge Clarke's order, and the newspaper comments thereon, rather than because of improprieties in the basic company operation.

The aforementioned familiarity with these sell orders, and Exhibit 6003 in its entirety, both *before and during the trial,* leaves no doubt that appellants knew exactly what was contained in the sell orders, and the types of documents and letters which customers had attached to them in closing their accounts.

On May 14, 1962, at the post-trial hearing of appellants' motions for judgment of acquittal, the trial judge expressed his consternation that appellants had not revealed their knowledge and concerns about the documents contained in 6003 to him at a time when he could have reviewed their objections in a timely manner so as to eliminate any "prejudicial" material from that which would be going to the jury. When Attorney Dunn pointed out that he hadn't brought it to the court's attention because ". . . I didn't find it out until after the documents had been in the jury's possession" and that "it happened at a time when it was too late to bring it to the court's attention", the court responded, at Reporter's Transcript 4361:

> "No, it is never too late. I could have still called it back from the jury, still called the box

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account. Will you kindly submit it for processing? Enclosed also is a statement signed by Mr. and Mrs. Sanders with regard to the SEC hearings."

No. 5124—Customer Watters: Attached to the Sell Order is a signed form letter, as well as a memorandum on TD&ME letterhead from the Santa Barbara office to the Administrative Department, wherein it is noted: "Enclosed is portfolio on TD 11654, Sell Order for withdrawal in full, and signed Affidavit re publicity."

back, and if it hadn't been tampered with—I just can't see, Mr. Dunn, if it was known to the defendants either before or after this was submitted to the jury, and before the jury returned its verdict, it was not proper, of course improper conduct not to inform the court.

I was interested in how that happened to be discovered at that time. That is all I have to say on that."

Prior to denying appellant's motions, the court again addressed itself to what it referred to as "invited error" on the part of appellants and amplified its feeling of how appellants had not met their obligation to advise the court of what they believed to be objectionable material in Exhibit 6003, and that they had "taken their chance" by remaining silent at a time when the court might have remedied the situation, if such would have been necessary.[72]

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[72]At R. T. 4379-4381, the court observed:

"However, there was the new question which was raised, or you might say new questions in connection with Exhibit 6003. Now with the explanation which we have here this morning, I feel that there was an obligation on, first of all, the part of the defendants, when the defendants knew that that particular material was in 6003, to so advise the court, and of course there is no doubt but that the court would have removed that from the file, and if there was other material in the file of a like nature, such as letters, there is no doubt but that the court would have removed that. I think the record here speaks for itself that during the course of the trial every time a matter was mentioned where some objectionable material was on an exhibit, that the court, if it admitted it at all, admitted it provisionally on the removal of the objectionable material. So in view of that fact, and of the further fact that before the jury returned its verdict that counsel for David Farrell was informed, at least, that the exhibit might be in the possession of the jury, and that that information was not called to the attention of the court, at which time the court might then have called for a return

As the court pointed out, there was no showing that the jury even considered the contents of Exhibit 6003, a point bolstered by government counsel's observation that the jury would have had difficulty in reading the "newspaper article" (which was then in court) because of the manner in which it was stapled to the accompanying Sell Order [R. T. 4373].

In *Finnegan v. United States,* 204 F. 2d 105 (8 Cir. 1953), *certiorari denied* 346 U. S. 821, a case presenting a similar problem, where the documents involved had *not* been introduced into evidence, yet mistakenly found their way into the jury room; the Court rejected the contention that the defendant was prejudiced, and in affirming the conviction, held:

> ". . . The question was raised on motion for new trial. The motion was not only entertained but this specific question was considered by the court and passed upon adversely to the defendant. The ruling of the court on motion for new trial is not ordinarily reviewable on appeal if the court entertained the motion and its decision thereon is not manifestly an abuse of discretion. . . . (cita-

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of the exhibits, in order to determine if the jury had in any manner investigated this particular exhibit, at that time the court could even have interrogated each of the jurors as to whether they had read the particular article. And maybe the court, if the jurors had said yes, why, at that time maybe the court would have declared a mistrial. But now the defendants have taken their chance, and whether the jurors or any one of the jurors read it, of course we don't know. I therefore feel that *if there was any error* committed in permitting this or the other exhibits containing, say, like material, if there are such, why, *that error was at least in part invited by the defendants* and that they should not at this time be permitted to claim that it should not have happened. . . ." [R. T. 4379-4381; Emphasis added.]

tions omitted). In the instant case, the court gave careful consideration to the motion and denied it on three grounds: (1) That defendant's attorneys who were present at the time the exhibits were sent to jury were under a duty to examine them and failed to object to the submission of the documents to the jury; (2) That the matters contained in the documents were cumulative to other evidence which the jury had heard and . . .

". . . Defendant's counsel had notice that it was the purpose of the court to send all exhibits to the jury and no objections were made . . . There was no showing that the jury in fact examined these exhibits and there is no evidence indicating that defendant was prejudiced by their having been placed in the hands of the jury. . . ."

It is submitted that the above quoted decision parallels the rationale of the trial court in the instant case, in its denial of appellants' motions for judgment of acquittal, and that the question here should be disposed of in similar fashion.

3. Appellants' Argument That Exhibit 6002 Was Not a "True Summary of Exhibit 6003 as Represented to the Court by the Government," Misstates the Context of Witness Cole's Testimony and the Stated Purport of Exhibit 6002.

Appellants argue that the government, through its witness Leroy Cole, misrepresented the purport of Exhibit 6002, and that it was not a "true summary of the content of Exhibit 6003," according to the dictionary meaning of the word "summary." They further suggest that: ". . . Unless the Court examined 6003,

in detail there would be no way for the Court to be made aware of its true contents."[73]

The partial quotation of Cole's testimony, wherein he stated: "We made a summary of the requests for liquidation that were on hand on June 8," does not fairly reflect the complete context of Cole's explanation of the subject of his compilation marked Exhibit 6002. Cole fully described his purpose in preparing Exhibit 6002, as follows:

> "Medvene: I place before you Government's 6002 and ask *what that purports to be?* (Emphasis added).
>
> "Answer: This purports to be a list of the individual requests for liquidation which were in the hands of the Los Angeles Trust Deed and Mortgage Exchange on June 8th, 1960. This lists the *customer number, the date of the request,* and *the amount that was requested for liquidation.* This consists of approximately eight hundred requests, and the total amount is $3,630,000. These are all dated in May and June of 1960." [R. T. 2798]. (Emphasis added.)

Appellants concede the accuracy of Exhibit 6002 as to its statistical content, and complain only that it did not include other information contained in the sell orders or letter attachments, comprising Exhibit 6003. (*E.g.,* The various reasons stated by investors for closing their accounts, etc.) Not only would such information have been quite outside the scope of Cole's accounting computations, but appellee finds strange the inconsistent atti-

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[73]Brief DF, pp. 48-49.

tude on the part of appellants by their present complaint that Cole did not also include this "prejudicial" material in Exhibit 6002.

In *Carlson v. United States,* 187 F. 2d 366 (10th Cir. 1951), when an objection was urged as to a compilation of figures made by an accountant, and taken from certain records, the court held at 372:

> ". . . All of this statistical data was taken from other exhibits which were introduced in evidence. It reduced these figures to concise form. It is not contended that the exhibits do not correctly reflect the information taken from a great number of individual exhibits. All the data shown by these exhibits were contained in other exhibits in evidence. Reducing it to a simpler form did not prejudice the rights of appellants and there was no error in the receipt of these exhibits."

Appellants are not only presenting an unsupported allegation to this court for the first time, but it appears a belated attempt to seek relief on a point which they elected to remain silent about in the trial court. That they were aware of the nature and "true contents" of Exhibit 6003 has been clearly demonstrated. Yet neither they nor their counsel chose to complain regarding the subject matter of Exhibit 6003, or that they did not feel that Exhibit 6002 depicted a fair summary of all of the documents in 6003.

4. The Government Did Not Mislead or Surprise Appellants as to Its Intended Use of Exhibit 6003.

The appellants contend that the government made spurious representations to the court when it "advised repeatedly that it was not going to submit the Exhibit 6003 into evidence and was not going to use it . . .".[74]

Contrary to appellants' statement, nothing said by government counsel misled them as to the intended use of Exhibit 6003. These documents were brought into court solely as underlying records to support Leroy Cole's computations found in Exhibit 6002. The necessity for the ultimate government offer was precipitated by appellants' own demands.

The documents comprising Exhibit 6003 were brought to the court's and appellants' attention in a discussion which occurred, out of the presence of the jury, on March 20, 1962; some three weeks prior to the end of the trial [R. T. 1628]. Government counsel advised that a box of records was available to appellants, which contained liquidation requests which LATD&ME had received prior to the close of business, and which had not been honored as of that time. Counsel further pointed out: "We think they have seen them all. They got all the letters"; that these documents had been "kept down at LATD and the defendants had as much access to them as we had"; and that they had been examined in 1960, as a part of underlying records, by an independent accounting firm [R. T. 1628-1631]. The government's position was clear that it did not

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[74]Brief DF, pp. 46-47.
Note: The reference at the top of Brief, DF, p. 40, to the government's "statement", did not refer to GX 6003.

want to, nor intend to offer the records comprising Exhibit 6003 into evidence, inasmuch as it contained only underlying records, *unless the court or defense counsel* wanted it in.[75] Thereafter, defense counsel made nu-

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[75]The context in which the government introduced GX 6003 appears at R. T. 1664-1667, and is not as stated by appellants (Brief D. F., p. 39):

". . . we tried with those records, and others, even if they are not going to be evidence, to give that information to defense counsel.

"We don't intend to use anything in that box, sir. But when a witness is on the stand and testifies that x amount of dollars, and so forth, were in liquidation, we just want to mark that information. They are the defendant's records.

"We are not going to introduce them and take the time of the court. But we just wanted them available to defense counsel.

". . . I think I conveyed to the court that we *wanted* to put them in evidence. *We don't.* It is just the underlying data.

"It is the same thing with the other accounting records that we are trying to get together. *We are not going to put that in as evidence, unless your honor wants it in or defense counsel wants it in. We have no objection to it, but it wasn't our plan to put it in. It is just the underlying data.* (Emphasis added.)

"We thought we could help expedite things if we presented it now."

"The Court: I understand your statement here now . . . It is here for counsel for the defendants to examine it . . . I understand that you will call witnesses, however, that have actually examined this material; is that correct?

"Mr. Medvene: Yes, sir.

"The Court: They will be expert witnesses that will say they have examined the records of LATD and that these records are the records here which you are referring to.

* * *

"Mr. Dunn: All I can say, your Honor, is that apparently the Government wants us to examine these for some reason. We don't know the purpose at the present time. If there is going to be accounting data submitted to this court, summaries and things of that kind, upon which this material is based, we need to have summaries in order to analyze

merous objections on grounds of lack of foundation or that the supporting records for particular summaries which Mr. Cole had prepared, were not present in the courtroom, and in evidence.[76] [R. T. 2787, 2790].

The Court sustained the objections and it became obvious that defense counsel and the court wanted the underlying records of LATD&ME to be admitted in order to support Mr. Cole's testimony. The government then, and only then, offered GX 6003 in evidence.

5. Exhibit 6003 Was Properly Admitted Into Evidence as Business Records of LATD&ME.

Appellants presently urge Exhibit 6003 is not a business record, and therefore is not admissible into evidence as an exception to the hearsay rule. Appellants did not raise this objection below, thus effectively precluding the court from remedying any possible gap in the record.

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them with the material. It would do no good for us now. . . .

"The Court: When are the summaries going to be available?

"Mr. Medvene: As far as the summaries are concerned, we submitted an exhibit register on them, and the summaries will be in this court five minutes after we close. . . ."

[76]After a discussion relative to another of Mr. Cole's accounting statements, GX 6000, and a showing that LATD & ME was insolvent to the extent of $1,250,000, the following colloquy occurred [R. T. 2790-2791]:

"Mr. Jacobs: I move to strike that, if the court please, on the ground that there is no foundation laid for it, the statements that he used, unless we have the record itself.

The Court: What do you mean by 'no foundation'?

Mr. Jacobs: The foundation would be in the work sheets, your Honor, and the records themselves.

The Court: In other words, you are raising the objection that the records on which he relies are not in evidence? Is that the question you are raising, Mr. Jacobs?

Mr. Jacobs: Right.

The Court: Objection sustained. And the answer is stricken."

Appellants' counsel not only did not raise this objection below, but expressly informed the court that Exhibit 6003 contained "business records" used by LATD&ME "during its course of business" [R. T. 4349; C. T. 530].

Assuming this court were to permit appellants to reverse their previously taken position, the government respectfully submits the records in question were admissible under the business records exception to the hearsay rule.

> 28 U. S. C. 1732 (Federal Business Records Act);[77]
>
> *Olender v. United States*, 237 F. 2d 859, 866 9th Cir. 1956, *certiorari denied* 352 U. S. 982 (1957).

The printed form entitled "Customer Sell Order" was prepared by LATD&ME and designed by them as a means through which investors might close out their accounts. The company anticipated partial preparation of the "form" by the customer; approval by the sales representative; and notations by the LATD&ME staff.[78]

> "All the hallmarks of authenticity surround this document, since it was made pursuant to established company procedures for the systematic, routine, timely making and preserving of company records." *United States v. Olivo,* 278 F. 2d 415, 417 (3rd Cir. 1960).

See also:

> *United States v. Tellier,* 255 F. 2d 441, 448 (2d Cir. 1958), *certiorari denied* 358 U. S. 821.

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[77]See Appendix Q.

[78]GX 1663. See Appendix R.

The cases cited by appellants are readily distinguishable from the instant case. In *Amtorg Trading Corp. v. Higgins,* 150 F. 2d 536 (2d Cir. 1945), the letter in question was not a record of any business transaction, made as a systematic routine during appellant's business. The "sell orders" in the instant case were routinely made, used, and retained as a part of the books and records of LATD&ME. In *Standard Oil Co. v. Moore,* 251 F. 2d 188, 213 (9th Cir. 1957), *certiorari denied* 356 U. S. 975 (1958), the subject documents consisted largely of interoffice communications concerning the marketing, pricing and practices of *other* oil companies and of competing service station operations. This Court pointed out that records are admissible under Section 1732 if they:

> " . . . reflect the day-to-day operations of a commerical enterprise . . . in which it is *directly concerned as a participant.* . . ." (Emphasis added).

LATD&ME's policy made mandatory the use of the form "sell order" as *the* specific document to be used, initiated by the investor, and processed by the company, to accomplish the liquidation of an investor's account.

The covering letters sent by some investors with their "sell orders" were deemed by LATD&ME as a necessary adjunct to the form itself. Of the 213 "sell orders" which *did* contain a customer letter,[79] 184 had a notation on the "Special Instructions" line, specifically adopting the attached letter by direct reference to it.[80] In addi-

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[79]The letters were all stapled to the "sell orders," ostensibly by the company.

[80]*E.g.,* "See attached letter for instructions."

tion, some customers, pursuant to LATD&ME's request, returned the company's "form letter"[81] which had solicited their assent that their liquidation was due to the adverse publicity the company allegedly had received. These "form letters" were similarly retained by LATD&ME as stapled attachments to their respective "sell orders."

In *Bisno v. United States,* 299 F. 2d 711 (9th Cir. 1961), certiorari denied 370 U. S. 952 (1962), letters were held to be admissible under 28 U. S. C. 1732. Appellant there contended:

> ". . . some of the correspondence in said exhibits was not written by him, and argues that letters, as distinguished from records of events and book entries, are not admissible as an exception to the hearsay rule permitted by the Official Records Act, Title 28, U.S.C.A. §1732. It is Bisno's position that the 'Official Records Act does not extend to documents which purport to be simply recitals, like letters. And those are not records kept in the due course of business at all.' " (p. 718).

This court disregarded such contention and held:

> "We do not regard the Official Records Act as being so restrictive. This act permits the introduction into evidence of 'any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, or occurrence, or events * * * if made in the regular course of any business, and if it was the regular course of such business to make such

[81] See footnote 70 for context of "form letter".

memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter. The mere fact that the memoranda taken from chronological files are in the form of letters does not operate to remove the materials in 58-A - 65A from the Official Records Act. Neither does the fact that some of the letters were not written by Bisno himself affect the admissibility of such letters under the act, since that act provides 'all other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but such circumstances shall not affect its admissibility' . . .

". . . Bisno has pointed to nothing about the form or substance of the correspondence appearing in Exhibits 58-A - 65-A which removes it from the ambit of the Official Records Act or places it outside the policy of exceptions to the hearsay rule contemplated by that act." (pp. 718-719).

See also:

Bodnar v. United States, 248 F. 2d 481 (6th Cir. 1957).

Appellants state "numerous notations by parties unknown" are found on documents contained in Exhibit 6003. There was no objection raised below as to the authenticity of these notations. The notations generally consist merely of initials, dates, times, or similar markings indicating they were made by personnel of LATD-&ME as part of their systematic procedure utilized in processing these documents.

The documents contained in Exhibit 6003 are clearly the kind of ". . . contemporaneous record of events, systematically prepared . . ." by LATD&ME for its own use and ". . . relied upon by it in the performance of its functions . . ." in liquidating investors' accounts.

La Porte v. United States, 300 F. 2d 878 (9th Cir. 1962).

It is submitted that the sell orders and their letter attachments were utilized as a systematic record keeping process, prepared for the purpose of expediting orderly liquidation of investors' accounts; and that they were material and competent, due to the intrinsic relation of the documents to the very nature of LATD&ME's business, and were properly received in evidence for the purpose offered.

6. No "Plain Error" or Substantial Harm Resulted to Appellants From the Admission of Exhibit 6003.

Assuming *arguendo,* this court were to find the records in question are not "business" records, and that appellants have not "waived" their present objection or "invited the error" of which they now complain, it is respectfully submitted that Government Exhibit 6003's admission into evidence was but "harmless error" within the meaning of Rule 52 of the Federal Rules of Criminal Procedure.[82] As the Supreme Court said regarding the existence of error in the record,

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[82]"Rule 52. Harmless Error and Plain Error.

"(a) Harmless Error. Any error, defect, irregularity or variance which does not affect substantial rights shall be disregarded.

"(b) Plain Error. Plain errors or defects affecting substantial rights may be noticed although they were not brought to the attention of the court."

> ". . . we cannot say that the ruling was prejudicial even if we assume it was erroneous. Mere 'technical errors' which do not 'affect the substantial rights of the parties' are not sufficient to set aside a jury verdict in an appellate court. *He who seeks to have a judgment set aside* because of an erroneous ruling *carries the burden of showing that prejudice resulted.*" *Palmer v. Hoffman,* 318 U. S. 109, 116 (1943) (Emphasis added).

Appellants have not carried their burden. Instead of showing "prejudice", they merely shout the word. Their excited statements alone do not play midwife to reality.

See also:

Lohmann v. United States, 285 F. 2d 50, 51, (9th Cir. 1960);

Gilbert v. United States, 307 F. 2d 322, 326 (9th Cir. 1962);

Smith v. United States, 173 F. 2d 181, 184 9th Cir. 1949).

Appellants contend that ". . . a cursory examination of the [approximately 800] letters will readily disclose that they contain highly inflammatory and prejudicial material . . . (See Brief DF, Appendix pp. 21-27.)" However, a more thorough examination of all of the sell orders and the letter attachments gives an entirely different impression than that portrayed in Appellant's Appendix (pp. 28 *et seq.*). Even the 51 items chosen by appellants as a "sampling" of the more

than 800 total gives lie to their claim of prejudice, as illustrated in the footnote below.[83]

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[83]*E.g.* No. 4702, Pearson, No. 4830, Dillman, and No. 6314 Meitus, are cited as "prejudicial" because they all refer to the civil judgment and newspaper accounts of Judge Clarke's statements. In actuality, the reference in each letter is the "form letter" furnished to the investor, and returned at LATD&ME's request, as an attachment to the sell order. No. 20479, Bell, also noted as "referring to the litigation and newspaper articles", actually states in reference to a previously received letter from LATD&ME, that the company had "enclosed some reprints from the newpapers regarding some litigation of which I had previously been unaware."

Six other of appellants' "sampling" expressly state an intention to reinvest with LATD&ME as soon as their present financial need is met. Examples, No. 4496, Gellibray (sic) should be McGillivray; No. 2777, Lemons; No. 3812, Watson; No. 1300, Whittaker; No. 20208, Class; and No. 20414, Padden. Further, No. 6675, Olsen, indicates only a *partial* liquidation. Examples of the specific language used by these investors, and claimed to be "highly inflammatory" are:

> No. 4496—"This money was placed with you for the purpose of buying a home and when this matter is settled we will place funds with you again . . ."
>
> No. 2777—"I am getting wedding (sic) next month and I will need the money for the wedding and the purchase of a house.
>
> "I would thank you for your trouble and tell you that my association with you has been most pleasant and profitable. I hope before to (sic) long to be able to open another account with you.
>
> "Thank you again."
>
> No. 3812—After requesting only a partial liquidation and noting that he intends to restore his account to the original balance, this customer concludes by saying: "I wish to express my appreciation of the efficient and satisfactory manner in which my account has been handled by your company."

Another six of the sell orders contain no such letter attachment from the customer, as so indicated by appellants. The complained of language in three of the orders is attached to TD&ME letterhead memoranda, referring specifically to action to be taken by O. J. Farrell (No. 2791, Jones; No. 2742, Whitson; and No. 1366, Bonjours.) The other three state the reason for liquidating right on the face of the sell order (No. 7154, Benjamin; No. 7153, Gebhard, and No. 2815, Eagle.)

A total of 733 sell orders contained in Exhibit 6003 either stated no reason at all for closing the account or only a non-critical reason (of LATD&ME); 530 of these did not even have a letter from the investor attached to them. In addition, 32 investors had comments of praise for the company or remarks to the effect that they had enjoyed a pleasant relationship with the company; and 53 declared an intent or hope to reinvest with LATD&ME in the near future (as seen in Appellants' own sampling).[84]

Regardless of what, if anything was attached to any of the sell orders, there has been no showing that even one of them was read in the jury room. This exhibit was accompanied by over 2000 numbered exhibits containing many more thousands of documents. Even had the jury explored each in detail, appellants would not have been prejudiced, inasmuch as the other evidence admitted during the trial, whether documentary or testimonial, stated virtually all of the matter now asserted to be "prejudicial" to appellants' interests.[85]

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[84]The "newspaper article" attached to the Max Skolnick sell order, was unique, and the only such example appellants were able to challenge out of this myriad of other sell orders.

[85]*E.g.* Witness West testified he rejected three trust deeds because LATD&ME had not met the specifications he outlined to them, namely: he did not want trust deeds which could be subordinated to further liens; or on vacant land; or which had insufficient security, or which were against overvalued land; or out of the Bay region. He also testified he had not received any earnings on his principal $2,500 investment, although his money was with the company from November 21, 1958 to June 8, 1959. This lack of earnings despite the fact that the monthly statements he received, showed regular increases in his earnings [R. T. 2188-2200].

Witness Penning's letters to LATD&ME complained that he had not received the $1,392.20 earnings on his account; the company failed to answer his four letters. [GX 2016]; the company

In the instant case all of the material in Exhibit 6003 was cumulative and the rationale of *Bisno v. United States,* 299 F. 2d 711, 719 (9th Cir. 1961), certiorari denied 370 U. S. 952 (1962) is here applicable:

> ". . . While Bisno complains that said exhibits contain many irrelevant writings, he has failed to point out any material in said exhibits which he claims to be irrelvant. He further contends that the introduction en masse of such exhibits prejudiced him in the eyes of the jury. Yet he fails to point out any material in said exhibits which misled the jury or erroneously influenced the verdict of the jury."

Similarly, in *United States v. Quong,* 303 F. 2d 499, 504 (6th Cir. 1962), certiorari denied 371 U. S. 863, the court, noting that certain documents were in substantial compliance with the provisions of 28 U. S. C. 1732, pointed out:

> ". . . However, in any event this documentary evidence was cumulative as there was . . .

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did not pay him the 10% return [GX 2071]; and that he liquidated because of his business needs [GX 2012].

Witness Beerup testified of her displeasure in having a delinquent trust deed in her account [R. T. 1063]; (LATD&ME's records indicating her trust deed had been delinquent since February 1, 1960) [GX 515, R. T. 1099].

Witness Henno expressed her concern to LATD&ME about the investigation of the 10% companies. She was told that LATD&ME was not under investigation; that the judge was prejudiced and that it was the newer companies other than LATD&ME who were being investigated [R. T. 1134-1139].

Witness Eppley testified that after reading about LADT&ME's litigation with the S.E.C. in the newspaper, she was worried about LATD&ME and went to visit the company with the intention of asking for her money [R. T. 768].

[other proof]. Some of the other record evidence was also cumulative.

"We believe and conclude that the admission of the documentary evidence by the District Judge, charged as erroneous, did not visit any prejudice upon the appellants, nor 'affect substantial rights' of the appellants. Rule 52(a) Federal Rules of Criminal Procedure . . ." (Other citations omitted).

See also:

Bailey v. United States, 282 F. 2d 421, 426 (9th Cir. 1960), certiorari denied 365 U. S. 828 (1961);

Stevens v. United States, 256 F. 2d 619, 623-625 (9th Cir. 1958);

Papadakis v. United States, 208 F. 2d 945, 952 (9th Cir. 1953);

Gordon v. United States, 164 F. 2d 855, 858 6th Cir. 1947); certiorari denied, 303 U. S. 862 (1948);

Finnegan v. United States, 204 F. 2d 105, 112 (8th Cir. 1953), certiorari denied, 346 U. S. 821.

It is respectfully submitted in the case at bar there was overwhelming proof that appellants designed and engineered the fraudulent nature of the business operations of LATD&ME. The admission into evidence of Exhibit 6003 did not affect the substantial rights of appellants, nor result in a manifest miscarriage of

justice.[86] As said in *United States v. Maisel,* 183 F. 2d 724, 726 (3rd Cir. 1950):

> ". . . Our search of the record fails to show that appellant was seriously prejudiced by the evidence. Virtually all of the vital facts have been conceded. Under the pertinent law they constituted overwhelming proof of appellant's guilt as charged in the indictment. The verdict was the only reasonable result which could have been arrived at by the jury."

F. The Evidence Is Sufficient to Sustain the Jury's Finding That Appellants Were Guilty as Charged in the Indictment.

The Government respectfully submits that the evidence is sufficient to sustain the jury's verdicts. Especially is this true when this court considers the evidence and inferences that can be drawn from it most favorably to the Government.

*Glasser v. United State*s, 315 U. S. 60 (1941);

Sandez v. United States, 239 F. 2d 239 (9th Cir. 1956);

Robinson v. United States, 26 F. 2d 645 (9th Cir. 1959);

Young v. United States, 298 F. 2d 108 (9th Cir. 1962) *certiorari denied* 370 U. S. 953.

Benchwick v. United States, 297 F. 2d 330 (9th Cir. 1961).

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[86]See: *Gilbert v. United States,* 307 F. 2d 322 (9th Cir. 1962).

As the Supreme Court said in *Glasser v. United States, supra* at 80:

> "It is not for us to weigh the evidence or to determine the credibility of witnesses. The verdict of a jury must be sustained if there is substantial evidence, taking the view most favorable to the Government, to support it. . . . Participation in a criminal conspiracy need not be proved by direct evidence; a common purpose and plan may be inferred from a 'development and a collocation of circumstances.' " (Citations omitted.)

The credibility of witnesses and the weight to be attached to their testimony is certainly a matter within the province of the trial court who has had the opportunity to see and hear the witnesses.

Stoppelli v. United States, 183 F. 2d 391 (9th Cir. 1950) *certiorari denied* 340 U. S. 864.

Norfolk v. McKenzie, 116 F. 2d 632 (6th Cir. 1941).

Appellee submits that the evidence presented at the trial, as indicated in the Statement of Facts, clearly was sufficient to sustain the jury's verdicts of guilt as to appellants.

Conclusion.

The appellants David Farrell and Oliver J. Farrell were convicted by a jury after a fair trial. Their contentions before this court are without substance or merit. The judgments and sentences should be affirmed.

Respectfully submitted,

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Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

EDWARD M. MEDVENE

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL and OLIVER J. FARRELL,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S REPLY BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

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APPELLEE'S REPLY BRIEF.

I.

Appellee's Statement of Facts Clearly and Accurately Documents Appellants' Scheme to Defraud.

Appellee submits that its Statement of Facts is an accurate and truthful summary of a complex criminal prosecution which lasted twenty-seven trial days, during which time more than 2,000 exhibits were introduced and over 4,000 pages of testimony was taken. The Statement, of necessity, was limited to the major points of appellants' scheme to defraud and could not and did not include all evidence introduced during the trial establishing appellants' misrepresentations and concealments in the creation, operation and offering of the Secured 10% Earnings Program to the investing public. Nor does the Statement give undue emphasis

to any particular aspect of the scheme to defraud such as appellant David Farrell attempts to do in his comments concerning "joint participation agreement" (Reply Brief, D. F. pp. 3-4).

Appellant David Farrell takes exception to the Statement of Facts, asserting that it "is a study in the use of hyperpole [sic], insinuation and omission." (Reply Brief, D. F. p. 1). However, despite appellant's blanket assertion, he is able to present only a few isolated instances in which the Statement of Facts is allegedly deficient. When closely examined, even these few meager examples show that appellee's Statement of Facts is completely supported by the record.

Appellant David Farrell claims that appellee's conclusion that $207,000 had been "misappropriated" in the Suisun Pierce Gardens transaction is not borne out by the record.[1] Actually appellee's Appendix A and Explanatory Note (9) establish that a portion of the $207,000 was in fact disbursed from the general funds of LATD&ME to William Bennett personally, and the remainder was disbursed to several of the numerous personal ventures entered into by David Farrell and William Bennett.[2]

In addition, David Farrell contends the record does not support appellee's ". . . characterization [in] . . . (Gov't. App. A, Item (X) (20)) that there was a joint venture agreement entered into by appellant in connection with the Palm Springs Alpine Estates transaction . . . ." Item X(20) does not in-

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[1]Appellant David Farrell's Reply Brief, pp. 1-2, footnote 1.
[2]Appellee's Brief, Appendix A, Item (L) (18).

dicate that David Farrell entered into a joint venture agreement relating to Palm Springs Alpine Estates, but rather that there were "Participations by David Farrell" in conjunction with that transaction.

In this situation, David Farrell personally acquired 320 acres,[3] which acreage was a portion of the larger property acquired by the developer from the original owner. This 320 acres was one-half of Section 25, which was one of the two most valuable sections in the area [R. T. 2316-2317], and it was not encumbered by any of the 653 trust deeds "purchased" by LATD&ME. Those trust deeds covered other property known as Palm Springs Alpine Estates [GX. 394].

Appellant asserts the government took "only a trainee appraiser's report" relating to the Capitol Park Estates tract in Sacramento, California as representative of the value of that property. This appraisal, so strongly objected to, was made by a member of LATD&ME's so-called appraisal department and was offered into evidence by appellant David Farrell [R. T. 3863]. On cross-examination, David Farrell admitted knowing the land had been valued at $666 per lot [R. T.

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[3]Under the terms of an Agreement dated April 18, 1960 between Lincoln Mining Corporation (David Farrell's corporation [R. T. 3939]) and Palm Springs Alpine Estates, Lincoln Mining Corporation transferred 10,000 shares of Southern California Land and Development Corporation stock, which stock had no material value [R. T. 3938], to Palm Springs Alpine Estates in exchange for a grant deed to the fee title to the "western one-half of Sec. 25, T. 5 South, R. 4 East, San Bernardino Base and Meridian, County of Riverside." This 320 acres was taken free and clear by Lincoln Mining Corporation and the Agreement specifically stated that "this conveyance . . . is not made for creating a trust or security deposit, nor an agency relationship with respect to either the land or the shares of stock conveyed." [GX. 400, 401.]

4134][4] but claimed the trust deeds were valued on what the "finished" value of the lot would be. Farrell realized it would cost between $1,300 to $1,700 to "finish" each lot, or that a total of well over a million dollars would be necessary to improve the 1,451 lots upon which trust deeds had been placed. Regardless of this fact Farrell testified that no money had been set aside for the improvement of the land [R. T. 4138-4139].

Appellant notes that William Bennett testified that the Capitol Park Estates land had been appraised by another appraiser at $4,000 per acre as raw land without utilities. Against 355 acres of this property 1,451 trust deeds were created, each having a face value of $1,350. Even utilizing the $4,000 per acre raw land estimate, it is readily seen that LATD&ME allowed each acre of land to be encumbered with at least $5,400 of trust deeds.[5]

Appellant David Farrell[6] also criticizes that portion of appellee's Statement of Facts[7] relating to the appraisal on the Villa Nipomo tract. Appellant refers to "the extensive evidence by Mr. Farrell," establishing the lots were to be developed as trailer sites. This "extensive evidence" amounted to one paragraph of David Farrell's direct examination where he stated the trailer sites "would have a value somewhere between twenty-

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[4]This amount was set out in Appellant's own appraisal report, Exhibit DF-AY, as the value for each "tentative lot" to be developed.

[5]Bennett testified this property could be divided into 4 to 4½ lots per acre [R. T. 1371].

[6]Reply Brief DF, p. 2, footnote 2(b).

[7]Appellee's Brief, pp. 34-36.

four hundred dollars and twenty-eight hundred dollars *upon completion . . .*" [Emphasis added; R. T. 4231]. Even if this were true, the "independent" appraisal offered into evidence by appellant David Farrell, supports the government's position that the trust deeds were tremendously overvalued when compared with either the raw land value of the property *or* the projected value, if and when it was developed.[8]

Appellant David Farrell claims his intent in entering into the joint venture transactions or participation agreements was "(1) to protect the company and its customers and (2) to defer income to . . . Appellant. . . ." Aside from the fact that David Farrell's objectivity was somewhat questionable when he entered into the numerous land transactions for LATD&ME, only advancing LATD&ME monies when and if he, in a personal capacity, took a share of the profits, it should also be noted that in several of the joint venture agreements no "protection" was afforded anyone other than the developer or David Farrell.[9]

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[8]Appellee's Brief, pp. 35-36.

[9]E.g., GX 148, a joint venture agreement, dated September 18, 1958, between George C. Goheen and David Farrell, which provides in part: . . .

> "WHEREAS, the parties to this agreement desire to combine their efforts and joint venture the development of subject property (i.e., Scott Highlands, located in Mill Valley, Marin County, California) for residential properties,
> "NOW THEREFORE, the parties do mutually agree from and after the instant date to joint venture the development and sale of the properties . . . upon the following conditions. . . .
> "Article VI:
> "Profits: Losses: The parties shall share equally in the profits and in the losses of the venture. . . .
> "Net profits shall be distributed to the members of the venture, annually, or at such other times as the parties may from time to time mutually agree."

Even in those agreements where Farrell claimed there was built-in protection for the customers of LATD&ME, the investors had no knowledge thereof, and these agreements could be changed at David Farrell's will (see, *e.g.,* the transaction with William Bennett where despite the "agreement" that the proceeds from the sale of the various Westgate lots would go first to retire the encumbrance on the Suisun Pierce Gardens property, David Farrell would not permit the lots to be released and the funds to be disbursed unless he personally received 50% of the profits [R. T. 1216, 1248-1250]).

II.

There Was No "Plain Error" in the Record and Appellants' Rights Were Protected at All Stages of the Proceedings.

As detailed in the Statement of Facts in appellee's opening brief, this was not a case where the evidence was "finely balanced." The overwhelming and massive weight of the evidence, consisting in large part of LATD&ME's own internal records, showed a plan and course of operation, designed by appellants, which succeeded in parting Secured 10% Earnings investors from millions of dollars of their hard earned funds. The investors were "secured" in the most part by greatly overvalued parcels of earth and the unfulfilled promises of the Farrells—the scheme's architects.

The Court in weighing the significance of any error alleged by appellants to be found in the 4,500 page transcript,

> ". . . must take account of what the error meant . . . *not singled out and standing alone, but in relation to all else that happened* . . .

> If . . . the error did not influence the jury, or had but very slight effect, the verdict and the judgment should stand. . . . (emphasis added).
>
> *Kotteakos v. United States,* 328 U. S. 750, 764 (1946).

Certainly a criminal appeal should not be turned into a quest for error. *Bihn v. United States,* 328 U. S. 633, 638 (1946).

As this Court said in *Gilbert v. United States,* 307 F. 2d 322, 326-327 (9th Cir. 1962), a verdict should be overturned only when the alleged error ". . . would result in a manifest miscarriage of justice, or would 'seriously affect the fairness, integrity, or public reputation of judicial proceedings' . . ." Certainly in the case at bar there is no ". . . plain error . . . affecting the substantial rights of the appellants, nor . . . any error which would result in a manifest miscarriage of justice . . ."

The cases cited by appellant David Farrell, in his reply brief, are clearly distinguishable from the case at bar in that the "error" alleged in those cases was found to affect the "substantial rights" of the defendants. In *Bihn v. United States,* 328 U. S. 633 (1946), the crucial issue was whether petitioner stole certain ration coupons from the bank. Petitioner did not take the stand, there was no direct evidence that petitioner stole the coupons, and there was a conflict in testimony presenting a question of credibility for the jury. Against this background the judge charged the jury ". . . Did she steal them? Who did if she didn't? You are to decide that." The appellate court, in reversing peti-

tioner's conviction, said that prejudicial error was committed since petitioner was not afforded the protection of the "presumption of innocence", as the trial court had instructed the jury that to justify acquittal it was the jury's duty ". . . (a) to decide that appellant committed the theft unless (b) they decided that some other person did . . .".

In *Bollenbach v. United States,* 326 U. S. 607 (1946), the jury, after deliberation, returned to the courtroom "hopelessly deadlocked." Then, in response to the jury's question regarding a "vital issue" in the case, the court's comments were found by the appellate court to be ". . . not even 'cursorily' accurate. He [the court] was simply wrong." In addition the jury after a "plain hint" from the court that a verdict should be forthcoming returned with a guilty verdict within five minutes.

In *Mora v. United States,* 190 F. 2d 749 (5th Cir. 1951) there was no substantial evidence against appellant apart from the confessions of his co-defendants. This testimony was improperly admitted against appellant without limiting instructions, since the confessions had been made after the alleged conspiracy concluded and in appellant's absence. Belatedly the court instructed the jury to disregard the confessions. It was only under these limited circumstances that the appellate court reversed the conviction holding there was no assurance that the jury had not been substantially swayed by the use of the confessions.

In *Little v. United States,* 73 F. 2d 861 (10th Cir. 1934), the judge permitted the court stenographer to attend in the jury room, outside the presence of de-

fendant or his counsel and to re-read the court's instructions. This procedure was found to violate the basic proposition ". . . that no one should be with a jury while it is engaged in its deliberations . . ." The court concluded by saying ". . . without exception, as far as we are advised, such procedure has been held to be error. . . ." This departure from well accepted principles, is a far cry from the situation presented by appellants in the instant case.

Nor was the error in *Braswell v. United States,* 200 F. 2d 597 (5th Cir. 1952) of a type remotely related to the facts before this court. In *Braswell,* numerous defendants were on trial for offenses involving the acquisition and transfer of marihuana. During the trial, and in open court in front of the jury, one of the defendants assaulted a United States Marshal, and received an assist from one of the other defendants. They were both subdued, and removed from the courtroom. Another defendant, also in the presence of the jury, attempted to swallow two yellow capsules and bit the finger of the policeman who extracted them from her mouth. The court refused to discharge the jury, after either occasion, and gratuitously commented to the jury that the assaulting defendant's actions were possibly due to his being under the influence of marihuana. The appellate court found that all of the defendants were prejudiced by the physical and violent scenes, involving only three of the defendants, as well as by the court's remarks, inasmuch as all had been arrested in the same raid on a cabin which was allegedly the scene of a marihuana party. The court also found, under these circumstances, that the trial court's comments were

bound to be highly prejudicial and to affect the substantial rights of the defendants.

Appellants' citations of *Hayes v. United States,* 112 F. 2d 676 (10th Cir. 1940) and *United States v. Grady,* 185 F. 2d 273 (7th Cir. 1950) add no new factual or legal principles. The *Hayes* case does no more than point out the general rule that ". . . alleged errors taking place during the trial of a criminal case must be called to the attention of the trial court, thus affording an opportunity for correction . . .". The court noted that nevertheless ". . . an appellate court may correct serious errors involving life or liberty of the accused, although not preserved by proper objection . . .", but refrained from doing so holding:

> ". . . a careful examination of the record convinces us that the asserted error falls far short of coming within the exception to the general rule."

In *Grady, supra,* a sworn affidavit attached to the Information, saying that all of ". . . the facts stated in the foregoing Criminal Information are true" was permitted to go to the jury. The affiant was not a witness in the case, nor had there been an opportunity to cross-examine him on the contents of his affidavit. Further, the court did not refer to the affidavit in its instructions or otherwise. There was no reason to believe that the defendant even knew the affidavit would be going to the jury. In this context, the court found that the affidavit might well have persuaded the jury to convict and held ". . . the submission of the affidavit to the jury was erroneous, [and] that it might have been harmful to the defendant and was. therefore, prejudicial . . .".

III.

The Trial Court Did Not Commit Error in Giving a Summary of the Previous Civil Litigation Between the Securities and Exchange Commission and the Los Angeles Trust Deed & Mortgage Exchange.

The court's ruling in *United States v. Satuloff Bros.*, 79 F. 2d 846 (2nd Cir. 1935), cited by appellant[10] is consistent with appellee's position before this court. In that case the court refused to permit appellants to introduce a civil judgment into evidence as conclusive proof of the decisive issue in the criminal case—who stole certain property. In the instant case, the court's summary of the prior proceedings was given only to indicate that charges had been made against LATD&ME, not that they were true.[11]

As appellee pointed out in its opening brief,[12] an LATD&ME investor, prior to depositing his money with the company, was entitled to have knowledge that LATD&ME had been charged with fraud and insolvency regardless of the truth or falsity of these allegations, so that he might make suitable inquiry before entrusting his savings with LATD&ME.

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[10]Reply Brief, DF, p. 9.

[11]See Appellee's Brief, p. 73, footnote 51 for court's summary of proceedings.

[12]Appellee's Brief, pp. 72-75.

IV.

The Court's Ruling Regarding Investor Losses Was Proper and Did Not Prejudice Appellants.

Appellant David Farrell asks "If Appellee had evidence that a particular trust deed was not as represented or that a particular customer suffered loss prior to the 'run' on LATD or the take over by the Receiver, why didn't it produce its witnesses, ask the questions and have done with it." (Reply Brief, DF, p. 10). This is exactly what the government did. The evidence is without contradiction that LATD&ME's brochures and other sales literature and the presentations made by its salesmen unequivocally conveyed the message that the trust deeds introduced by LATD&ME into the accounts of investors were prime, trouble free and well seasoned, with the property owner normally maintaining at least a 15% cash equity in the property [R. T. 1041; 1529-1531; 1925-1926; 2188-2189; 2259; GX 842; 843; 844; 992(b); 1668; 1669]. Investors were likewise informed that it was LATD&ME's policy to replace defaulted or delinquent trust deeds with trust deeds in good standing.[13] The government proved the falsity of these representations by calling witnesses and introducing evidence to establish that prior to receivership 2,717 trust deeds in investor's accounts, totaling $8,-500,000, were delinquent [R. T. 2779-2780; 2809-2811; GX 6001(c); Appendix L]; that delinquent trust deeds were introduced into the accounts of investors [GX 764; 1186]; that LATD&ME's confirmations failed to fully describe prior liens and contained spurious in-

[13]See Appellee's Brief, pp. 51-52.

formation regarding the underlying trust deed security [R. T. 1462-1463, 1484-1493; 1557-1558, 1565-1566, 1575-1577; GX 788; 796; 867(a); 869(a)]; and that LATD&ME's salesmen misrepresented the nature and quality of the underlying trust deed security [R. T. 1565-1566, 1578-1579]. The government likewise established that LATD&ME introduced many thousands of grossly overvalued[14] trust deeds into the accounts of investors, manufactured against raw land in which the developer had no equity [see *e.g.,* R. T. 1266, 1271, 1278, 1299; 1635; 2102-2103].

Thus, it is clear that the testimony by investors as to losses was merely cumulative of the mass of other evidence establishing lack of value of the trust deeds selected for the Secured 10% Earnings Program.

V.

Exhibit 6003 Was Properly Admitted in Evidence.

Appellant David Farrell, while noting that his attorney Mr. Dunn "had no knowledge of the true contents of Exhibit 6003 until the jury came in for further instructions on April 16, 1962," glosses over his own admitted familiarity with Exhibit 6003 as illustrated in appellee's opening brief[15] (Reply Brief, DF p. 14). Nor was his attorney without awareness of the possible importance of the exhibit, as illustrated by Attorney Dunn's comment when counsel for appellee and the court advised him the exhibit was available for inspec-

[14]See Appellee's Brief, pp. 29-38.

[15]Appellee's Brief, p. 90, footnote 67.

tion, approximately three weeks prior to the end of the trial.[16]

Appellee's opening brief[17] clearly points out that appellants are in error when they assert the government was ordered to excise extraneous and immaterial matter from Exhibit 6003. The transcript also makes it abundantly clear, that government counsel did not mislead appellants nor discourage them from a thorough examination of the exhibit.[18]

As the court said in *Finnegan v. United States,* 204 F. 2d 105 (8th Cir. 1953), *certiorari denied,* 346 U. S. 821, where certain documents not admitted into evidence.[19] went to the jury,

> ". . . Defendants counsel had notice that it was the purpose of the court to send all exhibits to the jury and no objections were made. There was no showing that the jury in fact examined these exhibits and there is no evidence indicating that defendant was prejudiced by their having been placed in the hands of the jury."

The judgment was affirmed in *Finnegan* and it is submitted that the situation in the instant case demands no less.

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[16]Appellee's Brief, p. 100, footnote 75.
[17]Appellee's Brief, p. 86, footnote 60.
[18]Appellee's Brief, pp. 99-101.
[19]See Appellee's Opening Brief, pp. 95-96.

Conclusion.

For the reasons stated herein and in the opening Appellee's Brief, it is respectfully submitted that the judgments as to both appellants should be affirmed.

Respectfully submitted,

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Special Assistant to the United States Attorney,

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Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

J. Brin Schulman,
Assistant United States Attorney.

No. 18241

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DAVID FARRELL and OLIVER J. FARRELL,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

PETITION FOR REHEARING.

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DAVID FARRELL and OLIVER J. FARRELL,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

PETITION FOR REHEARING.

To: Jertberg and Browning, Circuit Judges, and Burke, District Judge.

This is a Petition for Rehearing by Oliver J. Farrell upon the judgment of this Court affirming the conviction of Appellant in the United States District Court for the Southern District of California.

Grounds for Rehearing.

I.

The record does not contain substantial evidence viewed in the light most favorable to the Government to support the judgment. As a matter of law reasonable minds as triers of the facts could not find that the evidence excludes every reasonable hypothesis but that of guilt.

II.

In the Court's recitation of facts setting forth Oliver J. Farrell's participation in the affairs of LATD&ME and related companies, set forth on page 5 of the Opinion, the following facts are not supported by the record:

1. He edited literature that was mailed out to investors.
2. He furnished to investors false and misleading information concerning the liquidation policy of LATD&ME.
3. He instructed the regional sales managers that the salesmen, in selling the 10% Earnings Programs, should resort to sham references in reassuring investors that their investments could be quickly liquidated.
4. He assisted in drafting brochures sent to salesmen and investors which falsely represented the value and stability of subordinate trust deeds that were created against undeveloped subdivisions or vacant tracts of land.
5. He instructed salesmen to represent to investors that the subdividers who created trust deeds for LATD&ME against vacant tracts of land had made large cash investments in the subdivision, whereas, in some instances no investment had been made by the subdivider.

Respectfully submitted,

Sylvan B. Aronson,
Attorney for Appellant
Oliver J. Farrell.

Certificate of Counsel.

Sylvan B. Aronson, being one of the counsel for appellant herein, certifies to this Court that the Petition for Rehearing is presented in good faith and not for the purposes of delay.

Dated: September 5, 1963.

SYLVAN B. ARONSON

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

SYLVAN B. ARONSON